

Office of the State Inspector General

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**Review of “Red Flag” Indicators of Potential Wrongdoing
At the Retirement System Investment Commission**

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I. Executive Summary

This review was predicated upon a complaint from the State Treasurer's Office (STO) identifying "red flag" indicators of potential wrongdoing, which may include corruption, securities fraud, fraud, ethics violations, and breaches of fiduciary duties. The wide ranging "red flags," which were both general and specific, in the complaint were reviewed by the State Inspector General (SIG) for articulable facts and significance to predicate a basis for further review and investigation. The complaint was scoped by the SIG into six "red flag" issues of potential wrongdoing involving misconduct or mismanagement, which encompassed the vast majority of "red flag" data provided. Four (67%) issues related to suspected RSIC operational weaknesses, which were verified by the SIG, and the residual two (33%) pertained to integrity issues involving inappropriate RSIC employee travel and perks from the investment industry and inappropriately restricting information access to the STO. After review, the SIG determined there was no criminal conduct or wrongdoing at the RSIC pertaining to any of these six "red flag" issues (0%). One "red flag" issue (17%) had merit regarding RSIC restricting information to the STO, two issues (33%) resulted in process improvement recommendations, and three issues (50%) did not substantiate the "red flag" indicators.

This review determined these six allegations were just symptoms of three larger issues between RSIC and the Treasurer: 1) the adequacy of the RSIC's investment strategy and corresponding results, particularly with the emphasis on alternative investments (AI); 2) the adequacy of RSIC's operational infrastructure to support the professional management of a \$25 billion asset portfolio; and 3) the communication and relationship dysfunction between the RSIC, both staff and Commissioners, and the Treasurer and his staff. It now seems these communication and relationship dysfunction issues are increasingly overshadowing the substantive issues of investment strategy and infrastructure.

The heart of this visceral debate between the RSIC and the Treasurer over investment strategy centers on four variables: management fees; investment return; investment risk; and AIs (private equity, hedge funds, commodities, and real estate). Basic facts relevant to these four variables are:

- As a percentage of assets managed (\$25 billion), RSIC management fee expenses (\$296 million in FY 12) are higher than published public fund averages due to greater asset allocations to AIs, more active investing (less passive), and higher use of external managers due to internal staff limitations;
- Over the past five years, the RSIC's investment returns ranked (5th percentile-high; 95th percentile-low) 77th among its peer group at a 3.9% annual return (6.8% high; 4.7% median; and 2.7% low);
- Investment risk is a factor in producing investment return. According to RSIC's consultant, RSIC's volatility, a key variable in risk, has been much lower than peers over the past five years; and
- AIs provide attractive rates of return and add diversification to RSIC's portfolio, but due to AI's complexity and unique risks, the RSIC must have adequate due diligence capabilities to prudently select and manage AIs.

These basic mathematical and definitional facts are not at issue, and the areas of agreement between the RSIC and the Treasurer on these facts are greater than either would believe. Their disagreement surfaces in their conclusions drawn from these simple, common facts.

The RSIC asserts the data is consistent with its long-term investment strategy. The RSIC intentionally diversified its portfolio towards an emphasis in AIs (40%). AIs inherently require higher management fee expenses, but the projected benefits include higher returns in the long-run and less risk (volatility) of being impacted by the major fluctuations in the public equity stock market. Its portfolio design is more defensive to protect the portfolio when stock prices fall (bear market) as compared to peers with higher concentrations of traditional stock. As a natural consequence, RSIC will likely trail its peers in a rising (bull) stock market, which the United States has generally experienced over the past five years. Further, despite trailing its peer group in investment return over the past five years, RSIC asserts its “risk adjusted returns” are better, on average, than its peer group in the same time period.

The Treasurer’s optic is based on a pattern over the past five years of the RSIC’s annual investment returns continually trailing its peer group. An exacerbating factor is RSIC paying much higher investment management fees compared to peers, yet their investment returns still trail their peers. Given the complexity and valuation risks with AIs, the Treasurer does not necessarily agree AIs’ diversification benefits reduce overall portfolio risk, which then consequently undermines RSIC’s strategy providing the defensive portfolio posture to perform better than peers in a falling stock market.

The RSIC and the Treasurer both have a rational basis for their perspectives. Questioning an investment strategy which has trailed peer plans for five years is a legitimate debate. However, this legitimate debate based on two rational perspectives has degenerated into creating the current dysfunctional communication environment wherein each side accuses the other of disingenuously portraying this issue, particularly in the media, without the proper context.

Based on a variety of consultant reports and interviews, the RSIC’s infrastructure supporting its \$25 billion portfolio has historically lagged behind its operational tempo. A common theme intertwined in the STO’s allegations was suspicions caused by actual process shortcomings in management fee accounting, due diligence, and the investment contract approval, and RSIC seemed to not prioritize, until recently, addressing infrastructure process issues. One consultant astutely focused this issue in the simple management concept that “process protects.” The RSIC’s historical pattern of less than robust procedures and operational control processes heightens both the risk of operational error, as well as undermines management’s credibility in prudently executing its mission, which then opens it to criticism, both deserved and inaccurate perceptions. Certainly, there are many indicators showing the RSIC infrastructure has improved since late 2011. Based on South Carolina statute, the first annual RSIC fiduciary audit will fortuitously take place in FY 14 (07/01/2013 – 6/30/2014), which will have independent experts examine policy, procedures, and controls to bring clarity to this operational issue, as well as make recommendations for an ultimate resolution to this issue.

The genesis of the dysfunctional communication likely has its origins in RSIC’s process of disseminating confidential information. Initially, the RSIC implemented cumbersome informational access logistics for the Treasurer, as well as the larger issue of completely excluding his staff’s access to confidential information. Given the Treasurer’s investment strategy and infrastructure concerns coupled with his other statutory duties as the State Treasurer, the Treasurer insisted, without success, he needed to leverage his efforts through staff assistance which required their access to confidential information.

RSIC’s initial restrictive approach was likely the result of a conservative legal analysis. This, in turn, only ramped up the Treasurer’s information requests to RSIC staff in both volume and tone, which further strained the relationship. From an RSIC staff perspective, this information access issue has escalated tensions and

perceptions where staff fears ridicule, reputation loss, and even job loss with every response, which inherently slows processing time and contributes to a less than robust exchange of information. From the Treasurer's perspective, RSIC informational responses to the STO were lacking in timeliness, specificity, thoroughness, and sometimes went unanswered, which led to equal frustration by the STO. Additionally, the RSIC did not share, in the main, his sense of urgency in his strategy and infrastructure concerns, which added stress to the situation.

As the legal basis for limiting disclosure withered, or as RSIC acquiesced to the relentless pressure, RSIC has incrementally pursued a course of attempting to open the confidential information aperture. This process has been ongoing for 17 months in a variety of stops and starts, but has yet to achieve a result. However, the past two years of battle scars are so thick that complete unfettered access now will not restore the lost trust which limits access to the most important form of information---open, candid, and robust dialogue to facilitate understanding. The current informational cycle resembles litigation with over-emphasis on written documentation, often with requests taking on a subpoena tone, and RSIC staff communicates in a careful, if not defensive, manner fearing any inconsistent data having disproportional ramifications.

Regardless of how this communication dysfunction evolved, the core issue is access to information by a fiduciary. Lessons learned from the business crises of the past decade clearly demonstrate a common theme of boards of directors (fiduciaries) failing to act on red flag suspicions. The Treasurer has an affirmative responsibility to act on his suspicions, regardless of how others view the merits of his concerns, and anything short of full unfettered access in the most efficient and effective manner should not be tolerated. If the Treasurer abuses this full and robust access, then the Commission would have a basis to restrict, rather than start with a restrictive attitude towards a fiduciary.

This dysfunctional relationship has materially impacted RSIC operations in real dollars, primarily in lost and delayed opportunities as described by a RSIC staff member viewing new initiatives as *"not worth the battle."* An expert commented, *"take away trust, and everything grinds to a halt."* The RSIC is a cautious, tepid, and defensive work environment where initiative and creativity are dulled and even the smallest issue with the STO takes an inordinate amount of time to deal with, often never quite resolving. A fog of suspicion, agendas, and perceived political calculations have invaded RSIC decision making which is unhealthy, particularly in an entity entrusted to manage \$25 billion in others' money. RSIC Commissioners' relationship with the Treasurer has likely been irreparably harmed and restoration of trust is highly problematic, yet without a cohesive leadership team, the RSIC operations serving hundreds of thousands of beneficiaries will inherently suffer.

This intense RSIC and STO relationship, despite the increasing negativity and dysfunction, did have a "silver lining" benefit. Over the past two years, this conflict has encouraged RSIC introspection on both operational infrastructure and AI portfolio, in terms of portfolio concentration and fee structure, which have yielded some benefits. However, this conflict has clearly entered into a counter-productive cycle where information exchange or presentations tend to be skeptically viewed as slanted, self-serving, and having a bias towards fault finding, thus limiting common ground to move forward. In short, the workplace atmospherics are increasingly toxic and are undermining RSIC's energy and focus on its core mission.

Trust has to be re-established at the Commission through direct intervention by the Budget Control Board, which has a variety of options. The rhetoric, unhealthy criticism, fault finding tendencies, and a pattern of personal slights must end, and the parties need to solve problems, big and small, while face-to-face in the same room and not through email or the media. Then, the RSIC has to project transparency in all its actions and reporting to avoid misperceptions. Further, it must develop a reporting mechanism, which describes in clear, unambiguous terms RSIC's strategy and execution results integrating peer results and robust benchmarks.

Table of Contents

	<u>Page</u>
I. Executive Summary	2
II. Background	6
A. Objectives	6
B. Retirement System Investment Commission (RSIC)--History & Operations.....	7
III. “Red Flag” Indicators of Potential Wrongdoing.....	8
A. Misstatement of Management Fees in the Audited Financial Statements	8
B. False Representation of Investment Valuations in the Audited Financial Statements ..	10
C. Inappropriate RSIC Employees’ Travel or Perks Paid by External Managers.....	14
D. RSIC Has Inadequate Controls for Alternative Investment Management Fees	17
E. RSIC’s Process for Approving Investment Contracts Has Flaws	19
F. RSIC Inappropriately Restricts Information to the State Treasurer.....	25
IV. Root Cause Analysis of “Red Flag” Indicators	31
A. Dysfunctional Communications	32
B. RSIC Operational Effectiveness	33
C. RSIC Investment Strategy	35
V. Way Forward.....	38

Appendices: A - Summary of Findings & Recommendations
 B - RSIC’s “Deloitte Risk Assessment Progress Dashboard”
 C - Peer Universe Rankings, 3/31/2013, Hewitt, Ennis, Knupp Consultants

II. BACKGROUND

A. Objectives:

This review was predicated upon a complaint from the State Treasurer's Office (STO) identifying "red flag" indicators of potential wrongdoing, which may include corruption, securities fraud, fraud, ethics violations, and breaches of fiduciary duties. The wide ranging "red flags," which were both general and specific, in the complaint were reviewed by the SIG for articulable facts and significance to predicate a basis for further review and investigation. The complaint was scoped by the SIG into six "red flag" issues of potential wrongdoing involving misconduct or mismanagement, which encompassed the vast majority of "red flag" data provided. The SIG scoped the complaint and initiated a review of the following six "red flag" issues:

- 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);
- In FY 2012, PEBA, the administrator of SCRS, represented to its external audit CPAs the fair market valuation of 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;
- 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;
- RSIC has inadequate controls for the payment of AI management fees, to include an \$18.3 million dollar error in a specific AI;
- 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; and
- 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.

An allegation of a conflict of interest involving a Commissioner and a specific RSIC investment was not examined by the SIG inasmuch as the allegation was under current criminal investigation by the South Carolina Law Enforcement Division (SLED). Additionally, the STO alleged RSIC has violated state law by having 70% of its assets outside of the State's custody, and these assets should be brought back under the control of the State's custodian, the STO. The SIG assessed this as a legal issue for the STO to pursue through an Attorney General's opinion, the courts, or the legislature.

B. Retirement System Investment Commission--History & Operations:

The RSIC was established in 2005. It is led by seven Commissioners, to include the State Treasurer, financial experts appointed by the Budget Control Board (BCB) Members, a retired member of the South Carolina Retirement System, and PEBA's Executive Director, who is a non-voting member. The RSIC has a current staff of 35 and a FY 2012 administrative and overhead cost of \$6.4 million.

The RSIC was established to be responsible for investing and managing all assets held in trust for the SCRS, but was limited to only invest in fixed income instruments and a maximum of 70% in equities. In February 2007, the State's Constitution was amended to broaden RSIC's investment authority to allow for full diversification of the investment portfolio. To reach this full diversification objective, the RSIC targeted its portfolio in 2007 towards a 40% allocation in AI asset classes, such as private equity, real estate, commodities, opportunistic credit, and hedge funds.

The cornerstone of RSIC's investment strategy is its portfolio asset allocation to reap the long-term benefits from economic forecasts and asset diversification, which reduces portfolio fluctuations (risk) and provides a higher return over time. Using data from RSIC's most recent FY 2012 Annual Investment Report, it establishes an Annual Investment Plan, which sets policy to allocate its asset portfolio (\$25.2 billion) to take advantage of economic forecasts to impact investment returns and control risks. The policy allocations for the three asset categories of investments were public equity (29.0%), public debt (30%), and AIs (41%).

Within each of these three asset categories, there are a total of 16 specific asset classes with their own policy allocations. RSIC's investment return on its asset portfolio is a function of primarily two factors. First, allocate portfolio assets optimally to take advantage of economic conditions and the benefits of diversification. Second, the RSIC generally hires EIMs with asset class expertise to actively invest, so selecting a higher performing EIM earns higher returns. A consideration in RSIC's Annual Investment Plan is how to prudently invest in order to close the current \$15.6 billion unfunded liability gap between the portfolio's assets (\$25.2 billion) and its actuarial liability to employees and pensioners (\$40.8 billion). The current annual return target to close this unfunded liability is 7.5%, which is central to RSIC's long-term investment strategy.

The RSIC has settled on a general strategy of investing heavier in AIs and less in public equities and debt. Their rationale is two-fold. First, AIs provide opportunities for higher returns in the long-run than public equity and debt investments. Secondly, AIs investment returns have lower correlation to traditional public equity and debt, which reduces RSIC's overall investment return volatility (risk) and improves portfolio asset diversification. The downside risks of AIs are illiquidity, high EIM fees, difficult asset valuations, and overall complexity of the investment, which ideally can be reduced through active oversight by RSIC staff. Over the past ten years in the United States, AIs have outperformed other asset classes. Over the past five years, public pension funds have shifted 10% of their assets from public equities to AIs, with the current public pension fund averaging 20% in AIs. Still, public pension funds' AI allocations vary significantly from 0% to 61%, with South Carolina on the high end of the spectrum in AI allocations estimated between 43% - 58% of its portfolio, depending on the AI definition applied.

RSIC's asset portfolio management is a critical component in the overall success of the state's pension plans, particularly to address the current \$15.6 billion unfunded liability. Public pension plans depend on investment returns for roughly two-thirds of their funding, while employer and employee contributions supported by taxes comprise the remaining one-third. For many plans, contributions have not adequately funded promised benefits. The average U.S. pension fund has a 20% unfunded liability and South Carolina's is 38%. If RSIC is

unable to address the unfunded liabilities through investment return, then it would require an increase in government and employee contributions or reduced benefits.

III. Red Flag Indicators of Potential Wrongdoing:

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

Full “Red Flag” Issue: The FY 2012 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 EIMs.

Data Collection: In FY 2012, the SCRS Comprehensive Annual Financial Report (CAFR) had \$55,130,000 in investment expenses in the “Statement of Changes in Plan Net Assets.” In the notes to the FY 2012 financial statements, a detailed schedule of investment fees and expenses was provided listing individual EIMs’ fees totaling the \$55,130,000. This schedule was footnoted, *“A significant number of AI managers provide account valuations on a net of fee basis. Management fees are netted against investment income because they are not readily separable from specific investment income as of the financial statement reporting date; (investment) amounts are recorded and reported net of fees and therefore (management fees) are not included on this schedule.”* This “netting” effect was ultimately determined to be \$241,005,000 in management fees, which was over four times the reported investment expense (\$55,130,000).

Regardless if the \$241,005,000 in management fees were netted against assets or more explicitly reported as an investment expense along with an identical increase in investment income, the effect would be the same on the two primary financial statements, “Plan Net Assets” and “Changes in Plan Net Assets.” The only difference is a more accurate and detailed depiction of the total investment expense and investment income. The substantive impact of greater detail and disclosure pertains to the impact on a common analytical metric used when evaluating investment operations, which is the ratio of investment fees to net assets under management. The reported financial statement investment fees of \$55,130,000 produced a ratio of 0.21% of net assets (\$25,266,496,000); the actual investment fees of \$296,135,000 produce a ratio of 1.17%. Inasmuch as not all public funds report fees in the same manner, comparative data can be problematic. However, in the most conservative terms, RSIC overall fees were higher than published public fund averages. When compared to other state pension funds, the 0.21% would appear to be low, while 1.17% would be well above average. This ratio by itself is not determinative in an assessment of an investment operation, but the higher this ratio, the higher the justification in terms of benefits, such as higher investment returns or greater reliance on external managers rather than internal pension fund staff. There are other relevant factors in understanding this ratio, such as plan strategy and plan returns over a longer period, but this simple metric set the stage for further inquiry.

There is also an inconsistency with the FY 2012 SCRS CAFR’s “Financial Statement Section” (pages 35-69) and its “Investment Section” (pages 72-87). The “Financial Statement Section,” which contains the externally audited financials, the detail management fee expense schedule, as denoted above, reported \$55,130,000 (page 69). In the “Investment Section” covering the exact same FY period, the detailed management fee expense schedule reported \$296,135,000 (\$55,130,000 + \$241,005,000; page 87). The \$296,135,000 fee expense was footnoted, *“this schedule was compiled by the RSIC and provided to the SCRS subsequent to the issuance of (SCRS’s) financial statements...represent a good faith attempt to disaggregate amounts that are not readily separable (at time of SCRS financial statements).”*

Interviews at PEBA, the administrator for the SCRS CAFR, described the history of the FY 2012 SCRS CAFR reporting two different fee expenses for the same FY. This issue first manifested in the FY 2008 SCRS financial audit due to the RSIC's increased involvement with EIMs and AIs. These EIMs often provided data in terms of net asset value with the management fees already taken by the EIMS by reducing the investment asset, but these management fees were not sufficiently or timely itemized by the EIMs for inclusion in SCRS's annual financial statements. EIMs reported financial data in a wide variety of formats. EIMs also had to provide year end accrual data for the financial statements, which was extra work because SCRS's year end was 6/30, while the investment industry tended to have 12/31 year ends.

In FY 2008, the SCRS contacted a number of other public pension funds, as well as the American Institute of CPAs (AICPA), and these plans had similar data collection issues impacting their financial statement presentations, which resulted in a variety of financial statement fee presentations. The SCRS's data calls for this investment fee data was a new process for these EIMs, many of whom were unable to provide the complete data for SCRS's 9/30 deadline to enable the SCRS to meet the external auditor's 10/15 deadline to issue its opinion. In order to provide consistency, a fundamental accounting principle, in fee presentation, PEBA elected to record only those investment expenses invoiced and paid by PEBA, which was not unusual in the public pension industry at the time. Correspondingly, PEBA took the position to maintain this policy until such time it could timely itemize (separate) and validate these AI netted fees suitable for inclusion in the audited financial statement on a complete and consistent basis, rather than a piece meal approach which would add confusion in terms of consistency. This accounting policy decision was documented in a memo, dated 4/22/2008, based on the AI EIM fee data not being readily available to be included in its audited financial statements, which was permissible under authoritative accounting standards. This explanation was independently corroborated by other industry technical experts. A review of 10 recent state public pension plans' financial statements revealed a variety of fee presentations methods to include paid invoices only, net of fee, and four (40%) appeared to report all fees.

The FY 2012 SCRS CAFR had a publishing deadline much later in the calendar year than its 9/30 financial statement deadline, which allowed RSIC more time to continue to collect data for a complete, good faith, presentation of fee expenses in its "Investment Section" of the SCRS CAFR. Despite the fee expense differences for the exact same FY period, RSIC elected to present the more robust, transparent fee expense figure. A review of FY 2012 RSIC's individual Annual Investment Report (AIR), the report provided the ratio of investment expenses to total assets (1.17%) using the more robust management fee expense of \$296,135,000, which demonstrated full transparency. This FY 2012 management fee expense pattern in both the SCRS CAFR and RSIC AIR was consistently repeated in the four prior FY reports (2008-2011).

As RCIS improves its capability to collect management fee data on a timely basis, PEBA will change its reporting to fully expense all management fees, as well as the reciprocal income investment increase, in its annual financial statements to enhance transparency. At the time of this report, PEBA was considering fully reporting all management fees in this manner in the FY 2013 SCRS CAFR, but was still working through the feasibility logistics of data collection and fair presentation of the data issues in a comparative format with prior FYs.

SIG Analysis: The AI industry's capabilities for timely fee reporting were less than robust, and public pension funds struggled with this accounting issue. The RSIC demonstrated complete transparency in investment fee presentation in its Annual Investment Report since 2008, while the SCRS wrestled with the issue due to timeliness constraints in its data collection to meet its financial statement deadline which still persists, but has

improved, through the present. The SCRS's initial fee presentation in FY 2008 was certainly well justified based on its formal analysis of industry practice; the practical reality of an inability to obtain needed data; and permissible under authoritative accounting standards. There was no intent by SCRS to be deceptive with its FY 2012 management fee expense presentation in its financial statements, as evidenced by RSIC's fully disclosing total fees in the same report, as well as the four prior FYs, with explanatory footnotes. However, over time this administrative issue likely did not receive the attention it likely deserved, which was a pattern observed by the SIG during this review, and the RSIC did not really aggressively address this issue until 2011. The current challenge in changing its accounting method to improve transparency is RSIC has so many EIMs that the sheer volume, along with needed validation procedures in a compressed timeframe are inhibiting factors; yet, its fees in magnitude compared to peer plans should propel it towards greater transparency as soon as feasible. Ultimately, the certifying CPA for the SCRS financial statements was fully aware of this presentation issue which had no net effect on the financial statements; understood this common accounting struggle in the public pension fund sector; possessed specialized public pension fund experience in the variety of methods addressing this management fee presentation issue; and provided an unqualified opinion.

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

Full "Red Flag" Issue: In FY 2012, PEBA, the administrator of SCRS, represented to its external audit CPAs the fair market valuation of 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.

Data Collection: PEBA's representation letter to its external audit CPA of the non-readily marketable investments (AIs) was based on three factors: 1) PEBA's investment statements and cash flows reconciliations; 2) review of all AIs' audited financial statements; and 3) the RSIC's on-going due diligence procedures.

In August 2012, three months before PEBA's representation letter to its external auditors, a consultant's, Deloitte & Touche (Deloitte), report concluded, *"that RSIC does not maintain initial or ongoing due diligence and financial reporting controls to support the valuations provided by external managers."* According to the "red flag," it was improper for PEBA to rely on RSIC's on-going due diligence procedures given this consultant's statement pertaining to RSIC's due diligence controls. The RSIC's Audit & Compliance Officer confirmed the August 2012 Deloitte report by stating, "due diligence policies and procedures regarding investment valuations *"do not effectively mitigate the risks to the organization."*

At an 11/2/2012 RSIC Audit Committee meeting, this specific issue was discussed inasmuch as the issue had been raised the previous month. The Deloitte consultant advised the report cited in the allegation did not suggest a complete absence of these types of due diligence controls. The controls varied in degree and some controls were works-in-progress, but to say that there was no due diligence or no controls was not an accurate depiction of the report. The report also specifically states, *"while the Commission has made progress towards enhancing and improving its due diligence processes...the Commission has not consistently maintained or followed the procedures outline in the DD (due diligence) Guidelines (policy guide)."* The core issue appears to

be the Commission staff was not executing its own control policies in a consistent manner, but due diligence activities were occurring and just not formally documented.

The SCRS's external CPA, who also attended the 11/2/2012 meeting, said he saw no evidence to indicate due diligence was not present. On the contrary, his discussions with RSIC personnel clearly demonstrated their understanding and knowledge of the AIs. Due diligence was taking place, but enhancements were needed in standardizing RSIC's control processes. Because the due diligence was not systematically documented to serve as an adequate internal control, the CPA did not rely on the controls and expanded his audit testing procedures to value the AIs. The SCRS had compensating controls on this issue by its monitoring and reconciling investment statements and transaction activity at the IAs, as well as receiving AI's annual audited financial statements. The CPA independently tested 90% of the AIs for existence and valuation through confirmations, examined the AIs' 12/31 year end audited statements, and performed roll forward procedures reconciling the 12/31 audited asset values to the SCRS's 6/30 year end reported valuations.

Two RSIC investment staff, both who have been at RSIC since 2008, also strongly disagreed with the assertion RSIC lacked due diligence in its AIs, thus preventing RSIC from fairly valuing AIs. It was crucial for RSIC to be able to attest to these fair values inasmuch as it provides this representation in a letter to PEBA, which in turn PEBA relies upon to support its fair valuation representation letter to the external CPA. The RSIC asserted it met the American Institute of Certified Public Accountants (AICPA) threshold guidance, which generally includes 1) having sufficient understanding of the nature of the underlying investments, the portfolio strategy of AIs, and the method and assumptions used by fund managers to value the underlying asset; and 2) the totality of this information is sufficient to evaluate and independently challenge the AI fund manager's valuation. According to RSIC staff, RSIC's pre-investment due diligence is extensive, which is summarized in a written proposal presented to the Commissioners. Subsequent to approved investments, RSIC maintains frequent contact with each investment's manager through face-to face and telephonic meetings. RSIC questions external managers on transactions inconsistent with the contracted strategy. RSIC follows monthly reports of AI activity and questions EIMs on unusual fluctuations, and these AI returns are compared to peer groups to note unusual variations. Most importantly, RSIC has an external investment consultant heavily engaged in all pre-investment due diligence, which was recently required to more rigorously examine the entire portfolio periodically throughout the year. Many of the AIs also employ independent administrators to process all the accounting transactions and partnership valuation calculations which add another layer of comfort in AI valuations.

According to RSIC, valuations of AIs are not as difficult as described in the "red flag" issue because the majority of the AIs use investment strategies trading in public market securities which these funds' external auditors can accurately value during annual audits. For AIs such as private equity where assets can be entire small companies, the valuations can be more difficult. However, these investments are designed for the external manager to only reap its profits after the assets are sold and the investor, RSIC, earns its profit; thus the external manager has no real motive to inflate estimated annual valuations.

From a variety of sources, it is clear from the inception of AI investments in the FY 2008 timeframe, resources were devoted to moving the SCRS portfolio away from traditional public equities and into a more diversified portfolio which included emphasis on AIs. This emphasis came at the expense of developing robust administrative operations to manage and control the investment activity. Examples include:

- In a report dated 08/15/2008, Independent Fiduciary Services, a consultant, provided the results of an operational review at RSIC. Twenty-nine recommendations were made, to include developing systems to ensure the fair valuations of AIs.

- Former Chief Investment Officer (CIO) Robert Borden stated at a Commission meeting on 9/23/2010, *“the need to build out robust audit and risk functions is critical for a portfolio that is growing in sophistication and detail. He reported that a staff of 10 investment professionals is not appropriate for a \$24 billion plan.”*
- In the September 2011 Deloitte report on enterprise risk in 11 operational areas; seven (63%) were high risk, four were medium risk (37%), and none were low risk (0%). High risk was defined as missing control policies/systems, while medium risk was the need for improvement of existing control policies/systems.
- Former CIO Robert Borden stated at a Commission meeting on 9/15/2011, *“many of the consultant’s (Deloitte) findings should not come as a surprise to the Commission; while the Commission was no longer in the startup stage, there was still build-out occurring. He stated that when the Commission was formed in 2005, the main priority was diversifying the portfolio. The Commission was not seeking to build out its capabilities and infrastructure in a number of areas.”*
- Deloitte’s second report, dated August 2012, narrowly focused on EIM due diligence and investment portfolio valuations. The report acknowledged the Commission’s progress in improving due diligence, but noted it had not consistently maintained or followed its own new due diligence guidelines. RSIC proffered it did not have sufficient staff or resources to even be compliant with its own guidelines.

The dichotomy of RSIC’s assertion of its due diligence while RSIC’s processes inadequately provided documented assurance of managing due diligence risk was highlighted by events following former CIO Robert Borden’s resignation in late 2011. Upon his resignation, RSIC determined that due to Borden’s dominant role in AIs’ due diligence, RSIC initiated a major effort for staff to meet with every Strategic Partnership (SP) AI EIM to ensure RSIC had full understanding of the investment, as well as spread RSIC’s due diligence responsibility and points of contact for SP AI EIMs over a broader number of RSIC staff. Further, RSIC’s primary consultant, NEPC, conducted a six month review of all AIs in coordination with RSIC staff. This supports RSIC’s assertion of conducting adequate due diligence in FY 2012, but it also depicts the weak control environment where on-going due diligence was narrowly concentrated with one primary individual supported by inadequate standardized due diligence files. For example, this FY 2012 special review identified at least two AIs needing RSIC intervention with fees tilted too far towards an EIM or having operational execution deficiencies. In FY 2012, due diligence was not an institutionally systematic and rigorous process, but the plethora of substantive due diligence activity was occurring as demonstrated by discerning two AIs were underperforming requiring remedial action.

On 11/8/2012, the “RSIC Due Diligence Guidelines” were approved by the Commission, which covered both pre-investment and on-going due diligence. On 3/1/2013, RSIC and PEBA jointly approved “Valuation Policies and Procedures,” which focused on protocols to ensure fair value valuations of AIs in the financial statements. The Commission established a “Deloitte Risk Assessment Progress Dashboard” to track progress on recommendations from both the 2011 and 2012 Deloitte reports (see Appendix B).

SIG Analysis: The “red flag” complaint turns primarily on the issue RSIC did not have sufficient internal control records to document it met the AICPA guidance threshold test of 1) having sufficient understanding of the nature of the underlying investments, the portfolio strategy of AIs, and the method and assumptions used by fund managers to value the underlying asset; and 2) the totality of this information is sufficient to evaluate and

independently challenge the AI fund manager's valuation. From a records only perspective, the STO may have a point. But from an assessment of all relevant data, the RSIC certainly had a sufficient basis to assert it met this threshold test.

The "red flag" assertion the RSIC's internal control records were not sufficient, by themselves, to support the fair valuations of AIs directly implies RSIC could not have conducted sufficient due diligence to meet the AICPA's threshold test in fair valuations of AIs. By all accounts, due diligence was taking place and RSIC had a due diligence internal control system. The core problem was RSIC not rigorously documenting its due diligence within its own system to give it documented assurance. Given the extraordinary effort in FY 2012 by both RSIC staff and its consultant examining SP AIs after former CIO Borden's resignation, RSIC's ongoing due diligence was likely at its pinnacle in FY 2012. There is ample evidence RSIC met the AICPA's litmus test of having sufficient understanding of the nature of the underlying investments, the portfolio strategy of AIs, and the method and assumptions used by fund managers to value the underlying asset in order for management to independently challenge the AI fund manager's valuation. To illustrate this capability, the FY 2012 due diligence focus was able to discern two SP AIs underperforming requiring remedial action.

The notion of management conducting activities sufficiently but "just not documenting" is common in many audits. Audit experience demonstrates that well defined policy expectations along with expected documentation drives, on average, higher performance; the lack of policy and documentation inherently leads, on average, to lower performance. The lack of adequate internal controls to document due diligence certainly should raise a "red flag", but the ultimate test is the substance of activity rather than the form. As will be repeated several more times in this report, a consultant astutely focused this issue in the simple management concept that "process protects." The lack of an adequate internal control process heightens both the risk of operational error, as well as undermines management's credibility in prudently executing its mission, which then opens it to criticism, both deserved and inaccurate perceptions. Operating without documenting internal control activities creates these risks, but it does not equate, by itself, to a conclusion of inadequate basic due diligence to meet the basic AICPA threshold test when valuing AIs as suggested by the STO.

The SIG gives complainants wide latitude in articulating their concerns, but it took note of the STO's flawed analysis asserting that PEBA did not meet the AICPA threshold test in fairly valuing AIs through not doing anything to "*understand the nature of the underlying investments in each fund, the investment strategy of each fund, and the methods and assumptions used to value the underlying investments in each fund or to prepare each individual valuation.*" The STO certainly was aware that virtually every state public pension fund entity in the United States has its investment component within its overall retirement system operation, with South Carolina being an exception by having two separate agencies execute the retirement system's mission. So, for the STO to make the argument PEBA must replicate RSIC's investment due diligence infrastructure to meet the AICPA threshold test to value AIs for the SCRS's financial statements is a classic "form" argument. The STO completely disregarded the "substance" of South Carolina's unique situation in having two separate agencies executing this one mission. The RSIC's representation letter to PEBA on AI valuation was the foundation for PEBA's representation AI valuation letter to its external CPA. The notion PEBA, asserted at great lengths in the "red flag" letter, needing to duplicate RSIC's entire investment due diligence infrastructure to support its AI valuation representation letter to its external CPA gives a completely inaccurate impression.

Where is the line to sufficiently underpin management's due diligence to meet AICPA thresholds to appropriately value AIs? It is a judgment call. That is why external CPAs conduct independent audits to make these judgments. In this case, the external CPA with public pension fund expertise provided an unqualified opinion of management's financial statements with a full understanding of the weak internal control issue along

a qualitative assessment of the RSIC investment team's understanding of the AIs to represent its valuations couple with SCRS's compensating controls. Further, the CPA realized the internal controls were weak, so he placed no reliance on these controls and escalated his substantive audit procedures to compensate to ensure AIs were fairly presented in the financial statements.

The documentation issues underpinning this "red flag" have, according to RSIC and its new policies, been fully remedied. The annual SCRS financial statement audit will take place in the summer 2013 and a RSIC fiduciary audit is statutorily required in FY 2014. Both audits will be able to assess if RSIC has successfully remedied its internal due diligence and valuation processes and controls.

The due diligence and corresponding valuation issues can be traced back to a consultant's report in August 2008. Certainly most every new organization has its operations get ahead of its administrative capabilities in its infancy. However, when the organization safeguards tens of billions of dollars entrusted to it by state employees and the state government, having operations over-exposed to weak due diligence administrative controls took too long to fully address.

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

Full "Red Flag" Issue: 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.

Data Collection: The allegation was based on three factors. Initially, in 2011, the Treasurer requested former CIO Borden's calendar to help Borden with a budget presentation, but Borden immediately began to be non-committal and did not produce his calendar. This started the Treasurer's skepticism which was further increased in the Summer 2011 when he began to "hear things" about Borden. The STO did provide one specific incident of suspicious RSIC travel records. The last factor pertained to a Wall Street Journal (WSJ) article (3/20/13) where the Securities and Exchange Commission (SEC) was scrutinizing private equity and hedge fund managers for providing improper travel payments and perks. The WSJ article states these "private investment advisers" had long been largely unregulated with less oversight in how they billed their investors, in particular for expenses like travel, entertainment and consulting arrangements by an industry known for putting on occasionally lavish events.

The specific incident of suspicious travel was determined to be baseless after review of the pertinent travel records and relevant interviews. Even though the other two factors in this "red flag" issue lacked specificity, the SIG conducted a significantly deeper review than the complaint facts would ordinarily warrant inasmuch as this issue was set forth and inferred in a substantial manner in the complaint. Assertions included suspicions some or all of the SPs used SCRS invested funds to pay for various costs, including travel and entertainment, creating conflicts of interest between the SPs and RSIC staff taking these benefits, as well as RSIC may be confirming its high fee investment program and continue to receive perks from Wall Street.

Official RSIC travel is governed by the South Carolina Code of Laws. A review of RSIC's Travel Policy Statement No. 2009-3, dated 3/19/2009, determined that RSIC travel must adhere to specific limits on meals,

lodging, and miscellaneous expenses established by the State Comptroller General Office's (CGO) Policy on Reimbursement for Travel and Subsistence Expenses. Interviews of RSIC personnel clearly indicated an adherence to the Comptroller General's travel guidelines prior to the 2009 written policy and subsequent to its implementation.

Prior to beginning official travel, the traveler completes a Travel Information and Justification Form, which is approved by an immediate supervisor and then by the CEO/CIO or his designee. The CEO/CIO assistant(s) schedule flight(s) and secures lodging at the GSA rate. Upon travel completion, the employee submits a Travel Support Document (STARS Form 62), along with a Travel Certification By Employee For Reimbursement Form (CGO Travel 12/09 A). The documents undergo a compliance review by the administrative staff followed by entry into the electronic payment system for reimbursement.

Interviews were conducted of RSIC personnel directly responsible for the entire cycle of travel approval, document preparation, travel reimbursement, and final verification of approved travel expenses. These interviews included the current CIO, past and present assistants to the CIO, Administrative Manager, Strategic Partnership Director, Director of Internal Audit and Compliance, Operational Due Diligence Director, and Legal Counsel. These interviews noted all RSIC travel was paid for by RSIC. They had no knowledge of any RSIC employee's travel paid for by an EIM. All recognized, without any doubt or question, any travel or perk paid for by an EIM would be inappropriate. Several interviews and review of travel records noted several instances where Commission members were guest speakers at conferences, and the sponsoring conference paid travel expenses, which was approved in advance.

Inasmuch as former CIO Borden conducted the most travel interfacing with EIMs, every travel voucher during the period FY 2008 – 2012 was examined. The voucher reimbursements were consistent with RSIC procedures and CGO guidelines. Additionally, a 15% sample of all other RSIC employee and Commissioner vouchers revealed the same.

It was noted during many interviews that strategic partnership (SP) investment contracts allowed for investors, including the RSIC, to seek reimbursement from the SP for travel expenses related to due diligence and reasonable investment related travel. A common situation pertained to SP investment contracts setting aside positions for investors, including RSIC personnel, to serve on SP investment committees as part of the overall investment. Customarily, the RSIC CIO was appointed to these investment committees to represent the RSIC's interest. Despite the SP investment contracts allowing reimbursement for these travel expenses, the RSIC took the position of paying for employee travel with agency appropriated funds, due in large part to the S.C. Code of Laws and State Ethics Act. This was to ensure that even the appearance of a conflict of interest did not occur despite RSIC's fees to the SP created the legal opportunity to be reimbursed for associated travel expenses.

The most likely risk of violating RSIC's travel policy would be to travel and be directly reimbursed by a SP, which would result in the transaction being completely off the books and records of RSIC. Only one interview revealed the possibility of such an expense. A Commissioner recalled a conversation with former CIO Borden pertaining to an SP, possibly Apollo Palmetto (Apollo), paying for his travel as a board member. This Commissioner asked Borden if all Apollo board members received the same benefit, which was the case. To test this risk, former CIO Borden's calendar was reviewed for 2010-2011 to identify any travel, which was then traced back to RSIC travel vouchers. All travel was paid for by RSIC with the exception of two instances. These two occurrences were for travel undertaken by CIO Borden in conjunction with RSIC's investment in Apollo.

The RSIC was a major investor in the Apollo SP which was comprised of a number of underlying funds. In April 2010, the Apollo SP approved the investment into two underlying funds. In conjunction with this investment, CIO Borden, already on the Apollo SP Investment Committee, was appointed to the Boards on these two investments. In this capacity, Borden attended meetings of these Boards in Hamilton Parish, Bermuda on 7/26-27/2010 and 10/11-12/2011, and his travel was paid by these underlying funds.

As a RSIC representative, Borden's travel should have been reimbursed by the RSIC. However, no RSIC travel records could be located for the July 2010 and October 2011 Bermuda travel. Additionally, there were no public disclosure records for Borden's Statement of Economic Interest for FYs 2011 and 2012 indicating he received any reimbursement of travel expenses for these trips. The SP payment for the Bermuda travel was in contrast to prior Board travel for these two investments wherein RSIC paid for Borden's travel to New York in November 2010 and Toronto, Canada in July 2011. When contacted for clarification on this travel, Borden advised he could not recall the details of how his travel was paid. This travel to Bermuda should have also been reported to the BCB, which it was not, due to an annual requirement to report international travel.

The SIG requested confirmation from all 14 SPs associated with RSIC of any travel paid by an SP on behalf of an RSIC employee from 2006 to the present, as well as specific to former CIO Borden due to these two anomalous instances. All fourteen SPs responded to the SIG's inquiry with negative results, with two exceptions. First, Apollo reported the two suspected Bermuda board meetings in 2010 and 2011. In these instances, Borden traveled with Apollo personnel on chartered jets. All or a portion of those flights were paid for by the underlying investments in accordance with its policy which provides that directors shall "be paid all reasonable travel, hotel and related expenses incurred by them in attending and returning from the meetings of the Board, any committee appointed by the Board, general meetings, or in connection with the business of the Company or their duties as Directors generally." Although the SP payment was consistent with its policies, it was inconsistent, despite a Commissioner's apparent implied verbal approval, with RSIC's travel policies as well as similar travel serving as a board member. A second SP reported paying \$330 in December 2006 for car service from and back to the airport for former CIO Borden.

An issue of interest pertains to former CIO Borden's continuation as a board member of the underlying funds to RSIC's investment in Apollo after he resigned from RSIC. While employed by RSIC, Borden was an uncompensated board member. After leaving RSIC, Borden received compensation, albeit a nominal amount compared to his likely annual salary, as a board member of the Special Committee of the Conflicts Committee in October 2012, and was reimbursed for travel expenses. When the underlying investment was questioned about Borden's compensation for this 2012 committee meeting, it responded that upon Borden's resignation from the RSIC in December 2011, the entities on whose boards he sat then regarded him as unaffiliated with the RSIC. The SIG discussed this issue with the State Ethics Commission, and although there appears to be no violation of state ethics laws, it does create an appearance issue. This is the type of transaction that can fuel skepticism when a state employee involved in negotiating a state investment resigns his state position, then immediately begins a compensated relationship with the entity he previously negotiated with on behalf of the state.

SIG Analysis: The allegation was based on one specific incident of suspicious travel, which was baseless, and the Treasurer's general suspicions about former CIO Borden's travel and a Wall Street Journal article. The SIG review determined a strong adherence to state travel policy and State Comptroller General guidelines. In some cases employees, to include senior RSIC management, paid for portions of travel with personal funds. Even for the period of time when a formalized travel policy did not exist, adherence to state travel guidelines was in place. In addition to the travel record review, interviews of key RSIC personnel failed to identify any instance

of abuse of travel or questionable behavior by RSIC personnel on official RSIC travel, with the exception of former CIO Borden's inconsistent travel reimbursement pattern for travel pertaining to his uncompensated board duties on behalf of the RSIC, as well as a nominal expense (\$330) for car service in 2006.

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

Full "Red Flag" Issue: RSIC has inadequate controls for the payment of AI management fees, to include an \$18.3 million dollar error in a specific AI.

Data Collection: Through interviews with RSIC staff and Commissioners, it was determined that prior to August 2011, the fee validation process was limited to a high level reasonableness assessment by investment staff without a formal process or documentation. As a result, \$925 million dollars in management fees for the period of FY 2008-2011 were paid to EIMs for AIs with nominal management oversight for accuracy and compliance with often complex investment contract terms. Subsequent to August 2011, RSIC initiated a focused effort, supported by staff hiring, to establish a formalized fee validation process.

The vast majority of RSIC management fees pertain to AIs through recurring EIM fees based on assets under management and performance fees based on results. The EIMs responsible for the AIs directly deduct these fees from the investments without ever sending RSIC a traditional invoice to be paid. Historically, EIMs did not report fee deductions on an interim basis – either monthly or quarterly – but did report on an annual basis. To meet financial statement requirements and more timely management fee validation needs of public pension plans, to include RSIC, EIMs are now being asked to provide fee information on a quarterly basis. The RSIC staff is also negotiating for more robust and timely information to be provided under new SP agreements, as well as requesting more information from EIM of SPs.

The current RSIC fee validation process involves staff recalculating the fees using the terms stipulated in the investment contracts, which is then compared to the fees reported by the EIMs on a quarterly basis. If any difference exceeds certain thresholds, additional validation efforts are undertaken to resolve the differences. Following the end of investments' FY, often 12/31 year ends, and receipt of the investments' audited financial statements, the interim quarterly fee amounts are compared to the total fees reported in the audited financial statements for an independent validation. The current process is essentially a manual, time consuming process.

In a survey of eight other public pension funds, all generally followed fee validation procedures similar to RSIC for AI fees. The processes involved recalculating fees on an interim basis using contract terms and following up with EIMs if differences in the EIM's reported fees were encountered that varied beyond thresholds. On an annual basis the recalculated fees were compared to fees reported in audited financial statements from the EIMs. Two of the funds reported this process has been contract out to third parties. All funds confirmed the historical progression of difficulties in obtaining timely fee information as RSIC reported, but indicated the EIMs were becoming much more forthcoming in providing the needed information. In relation to timely fee information, some funds, to include RSIC, reported the utilization of various independent, technology-rich sources of obtaining fee information such as independent administrators, financial services companies, and bank custodians.

In March 2012, the RSIC reported it overstated management fees by \$18.3 million in FY 2011 due to a reporting error. As described earlier in this report, the EIMs managing RSIC's AIs operate with a 12/31 FY year end, while the RSIC has a 6/30 FY year end. This tends to add extra complexity for EIMs preparing data for RSIC to meet its 6/30 FY year end financial needs. One EIM managing an AI inadvertently reported to RSIC its FY 2011 management fees using all four quarters of calendar year 2010 (1/1/2010 – 12/31/2010) and the first two quarters of calendar year 2011 (1/1/2011 – 6/30/2011). Inasmuch as RSIC FY 2011 should only have included four quarters (7/1/2010 – 6/30/2011), the EIM reported a total of six quarters resulting in \$18.3 million in excess fees.

As an aside, the EIM's corrected FY 2011 report of RSIC fees was dated 2/15/2012. The STO's initial inquiry on its suspicions of an overpayment occurred on 3/5/2012. RSIC did not notify its Commissioners until 3/14/2012 of this rather sizable reporting error. According to the RSIC staff, it initially notified the Chairman, and then conducted a systemic review of all other managers' fees which took some time. The intent was to report the over reporting error along with logical follow up review at one time to the Commissioners, and this timetable was unrelated to the STO's inquiry.

SIG Analysis: While the cause of the \$18.3 million overstatement error was obvious from reviewing the various reports, the SIG analysis took the additional step of reviewing and confirming the reported net asset value (NAV) amounts were not adjusted following the correction of the reporting error by the manager. It is important to understand this was a reporting error, rather than an overpayment by RSIC of fees. There was no impact on the two primary financial statements, "Plan Net Assets" and "Changes in Plan Net Assets," because the EIM fees were netted against assets accurately. The only financial reporting impact pertained to the RSIC FY 2011 Annual Investment Report schedule of fees, which was overstated by \$18.3 million.

Given no formal process prior to August 2011, the current fee validation process has obviously made significant strides in improvement. Its process and methodology appears to be comparable to peers. This process is still labor intensive, and both costs and assurance can be improved by enhanced EIM reporting and technology improvements, such as the "Private I" asset management system under consideration to be purchased.

The SIG observed the fees and expenses in investment transactions are routine in the investment industry, and there seems to be trust within the industry on accurate EIM reporting. From a non-industry perspective, a small percentage (1-2%) of a very large number (billions) is a large number (millions) by state government standards, thus requiring a high level of accountability to tax payers and state beneficiaries. Pass through expenses from strategic partnerships are exponentially smaller than management fees, but some expenses may be inconsistent with state government. For example, how was the private jet twice used by former CIO Borden billed to partnership expenses and what portion was paid by RSIC? The expense, if billed, was likely appropriate within the partnership contract terms, and immaterial to a billion dollar investment. However, it is this accountability piece to ensure such expenses are not inconsistent with state standards and prevented that seems to be driving the Treasurer's focus on transparency in this area. The RSIC, as well as the industry, is moving to close this gap, but it is still a risk to be fully addressed to a level expected of a state agency rather than an investment business. Technology and risk based testing are the direction to further provide assurance of a judicious use of resources.

While reviewing the \$18.3 million fee overstatement, the SIG noted the inordinate resources, time, and elongated review consumed for what appeared to be a straight forward business issue. For example, the \$18.3 million fee overstatement came to light in March 2012. The STO inquired as to the details on 3/5/2012. Over the next 18 days, 13 emails, and one conference call, this issue was thoroughly discussed and apparently came

to a conclusion. Then, from May through July 2012, another email chain on the same event begins totaling 30 emails and another face-to-face meeting with the Treasurer. Apparently, this issue is still not completely resolved at the STO as evident in its letter to the SIG, dated 4/9/2013, “*but never received an adequate explanation.*” A fiduciary taking interest in an \$18.3 million error is not only reasonable, but commendable, but it seemed to take an inordinate amount of time to address and the STO still does not seem fully satisfied. This was a common pattern identified by RSIC personnel with Treasurer inquiries.

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

Full “Red Flag” Issue: 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.

Data Collection: Prior to the 7/19/2012 RSIC Commission meeting, the formal approval process for investment contracts began with a staff proposal to the Commission. If approved by a Commission vote, the RSIC staff would proceed with finalizing negotiations and the legal investment contract documents. The staff then presented the final investment contract to the Chairman for approval and verbally advise of any changes in the traditional boilerplate contract language or terms. The Chairman’s sole signature was all that was required for approval.

This process, according to the complaint, was flawed because the possibility existed the approved proposal by the full Commission could be materially changed during staff negotiations, thus violating the intent of the Commission’s initial proposal approval. There was no formal document prepared by staff reconciling any changes during negotiations between the final investment contract and the original proposal. Interviews of current and former RSIC Chairmen described staff verbally highlighting to the Chairmen any changes in the final contract from the proposal or changes in the standard agreement terms generally used by RSIC. The Chairman would review the investment contract, which had standard boilerplate RSIC language terms simplifying the review. If there were minor differences, the Chairmen, in their minds, still had the authority to approve solely with their signature.

The allegation identified one specific investment, a strategic partnership (SP), where the final investment contract approved by the Chairman allegedly had higher management fees than in the proposal approved by the full Commission. A RSIC Internal Audit Report, dated 4/5/2013, analyzed this issue. The SP was presented and approved for an asset allocation up to \$3 billion for the purpose of consolidating and developing RSIC's core hedge fund program to lower overall investment costs and improve transparency. The five page RSIC proposal memo included a statement on the first page that total fees would be approximately 50 basis points (financial term for 1/2 %) and the SP would provide advisory services for direct and opportunistic hedge fund allocations (investments). A table within the proposal memo, super-copied from the SP proposal attached to the RSIC memo, showed a second and slightly different estimated fee total of 52 basis points (bps). The RSIC audit report also stated the proposal memo did not "*clearly convey the availability and opportunity for selection of various underlying investment vehicles within several investment categories, each with the potential of a different advisory and administration of program fee structure that ranged from 0 – 65bps.*" The final investment contract reviewed and signed only by the Chairman listed fifteen investment opportunities along with their associated fees which varied, none of which was set forth in the proposal memo. This RSIC report further noted that the Chairman for this SP investment stated, "*he never took the 52 bps noted in the proposal memo as the final fee schedule, and he understood the word "proposed" to mean "blended rate."*" The Chairman went on to note he didn't think the SP would invest in a "fund of fund" (fund portfolio composed by selecting multiple hedge funds managers) likely based on the SP's intent to directly invest in hedge funds, but acknowledged the agreement probably gave discretion to do so.

This RSIC audit report analyzed the SP's individual investments (23), along with their unique fees (0-65bps), and then determined the SP fees paid averaged 40 bps for all investments, which was 12 bps less than the SP proposal memo fee estimate of 52 bps. Despite realized fees being less than estimated, the report made two recommendations to address the shortcomings in the proposal memo:

- 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. If there is a possibility of fees varying, that fact should be disclosed and the estimated potential fees should be disclosed. The recommendation continued by stating that the Commission should be notified when any fee associated with an approved investment vehicle is materially outside of the estimate in the proposal to the Commission.
- The second recommendation calls for the establishment of a procedure to ensure that fees included in the final partnership investment contract are materially consistent with the fees or estimated fees included in the investment proposal approved by the Commission.

The SIG independently reviewed four randomly selected direct investments, which, unlike the SPs, have all material factors of a specific investment established at the time of the RSIC staff proposal memo. Two contract investments were identical to its corresponding proposal memo, while the other two had terms marginally better than in the proposal memos. RSIC staff advised that it was not unusual to receive marginally better final terms in direct investments. Investment fund managers do not want to publically disclose preferential rates for RSIC in the Commission's public forum which would impact its other clients, so preferential terms are factored into the final confidential investment contract.

The investment approval process was formally changed during the 7/19/2012 Commission meeting. There was general agreement RSIC staff should provide investment proposals to the Commissioners at least 30 days prior to a scheduled Commission meeting considering the proposal. This would allow Commissioners more time to review investment proposals before voting. This led to a fairly lengthy dialogue on allowing Commissioners 30

days to review the staff's final draft investment contract for due diligence and ensure it was consistent with the original proposed terms approved by the Commission. This resulted in passing the following motion, *"the Commission would not move to a final investment contract unless each Commissioner has a minimum of 30 days to look at all final documents."* RSIC staff proposed, which was endorsed by Commission members, to "fill in and flush out some of those details with respect to the implementation."

Based on a review of the minutes of Commission meetings prior to the 7/19/2012 meeting, the typical motion made to approve an investment had the following language, *"A motion was made by _____ to approve an investment of \$_____ in _____ and to authorize the Chairman or his designee to negotiate and execute any necessary documents upon approval for legal sufficiency by the Commission's legal staff, to implement the investment."* Following the action taken by the Commission in the 7/19/2012 meeting, motions made to approve investments included the following additional wording inserted after approval for legal sufficiency, *"and upon expiration of the minimum 30-day review period by the Commissioners as adopted by the Commission on July 19, 2012."* The language in both motions authorized the Chairman to execute the investment contract. However, it should be noted, the RSIC staff did not develop policies or procedures to "flush out some of those details" in the motion, and the motion was silent on the procedures if a Commission member objected to the final investment contract during the 30 day review period. There was discussion pertaining to a possible need for a second vote on the final investment contract, but it was not contained in the final motion.

In Commission meetings on 9/20/2012 and 11/8/2012, a total of five investment proposals were approved by the Commission under the new "30 day rule." In one investment, the 30 day review period was waived due to the need to move quickly to enter into and fund that investment. Two of the other investments were funded without issue. It appears the first implementation difficulty with the new "30 day rule" for investment contracts was encountered in the fourth investment, T. A. Realty Associates Fund X (TA).

On 11/27/2012, which was during the TA's 30 day investment contract review period, the Treasurer officially objected to the TA investment contract based on his inability to obtain a hard copy of the TA investment contract. The Treasurer was unable to print the TA document, because RSIC restricted printing from the RSIC secure Internet portal for security reasons. He stated it was unreasonable for him to read hundreds of pages from his computer, and he was unable to make notations on the documents. He wanted to be able to print from his computer or be provided a hard copy of the TA investment contract.

The 30 day review period for TA closed on 12/19/2012. On 12/21/2012, a RSIC email notified the Commissioners that Chairman Williams executed the TA investment contract. Within an hour, the Treasurer noted his prior objection was not addressed as he requested. On 1/11/2013, the Treasurer raised the issue of a required second vote on TA. On 1/15/13, Chairman Williams notified the Treasurer that the TA capital call needed funding by 1/17/2013, and there was no provision for a second vote on TA. The Treasurer responded concisely setting forth his concern, *"RSIC was given notice that a Commissioner objected to this agreement and the Commission has made no effort to call for a vote or settle this issue (hard copy of TA investment contract)."* The Treasurer attempted to set up a lawful meeting, which he felt was inappropriately blocked by the RSIC Chairman and CIO, while, of course, RSIC believed it prevented a meeting unlawfully set up by the Treasurer from violating public notice laws and Treasurer misrepresentations. There was no meeting, and the Treasurer ultimately funded TA, which was not in default only because TA provided an additional day for funding. In the Treasurer's final email to RSIC on the topic, the friction caused by events was clear, *"the dishonorable activities of the Chairman and his senior staff leave me astonished and with the realization that no good works accomplished tomorrow can survive the taint of their malicious intent...As custodian of the funds of the*

Retirement System (Treasurer function) I will issue a directive effective next week that will clearly state the new requirements needed for funding new investments."

The next investment contract circulated to the Commissioners pursuant to the new "30 day rule" was the Warburg Pincus Fund XI (Warburg), which was sent to the Commissioners on 1/30/2013 with the review period closing on 3/1/2013. Even though this was the fifth investment contract proposal approved under the "30 day rule," this contract had an additional nuance of requiring "documented approval" for legal sufficiency. This language was added in the investment contract's Commission approval motion on 11/8/2012 to ensure legal sufficiency was in a documented format, as opposed to the current practice primarily relying on staff orally briefing the Chairman of any changes in the final investment contract from the original proposal approved by the Commission.

On 2/5/2013, the Treasurer informed the Commission the STO was unable to process the Warburg funding request based on the same rationale set forth in his objection to the TA investment contract, *"the investment totals 564 pages in 15 separate documents. The Investment Commission makes the unreasonable and possibly illegal demand that I alone must read (online without the ability to print), understand and verify this information personally, without the assistance of staff attorneys, bankers or accountants."* The STO's funding was contingent upon the singular issue of the Commission complying with *"previously made requests for reasonable document access."*

At the 2/28/2013 Commission meeting, the Commission agreed to provide the Treasurer a hard copy of the Warburg investment contract and extended the review period deadline from 3/1/2013 to 3/18/2013 to allow him time for his review. This required the Warburg closing to be postponed from 3/4/2013 until 3/28/2013.

Several days before the 3/18/2013 review period closing deadline, emails reflect two additional issues raised by the Treasurer. These issues pertained to needing additional data to facilitate the STO's custodial arrangements to fund the investment, as well as questioning the documentation for the investment contract's legal sufficiency. On 3/18/2013, the RSIC staff sent an email to all Commissioners itemizing the Treasurer's issues along with RSIC's staff response addressing his issues. On the same day, Chairman Williams approved the Warburg investment contract. On 3/19/2013, the Treasurer reiterated the STO will not fund Warburg because his questions were not fully answered.

An emergency Commission meeting occurred on 3/28/2013 to address the Warburg investment which had not been executed, yet its closing was scheduled for the same day. At this meeting, the Treasurer succinctly clarified his concern asserting the investment contract was not legally sufficient because he has not been given a document in writing signed by the General Counsel certifying legal sufficiency. The Treasurer advised the RSIC's verbal statement and email of legal sufficiency was not sufficient, particularly due to another attorney at RSIC authoring the email rather than the General Counsel. The RSIC, on the other hand, disagreed with the Treasurer and felt its "documented" format was sufficient.

The RSIC then petitioned the South Carolina Supreme Court to determine if RSIC was entitled to require the STO to fund Warburg. On 4/15/2013, the day before the Supreme Court hearing, the STO funded Warburg based on Supreme Court hearing documents received from RSIC satisfying the legal sufficiency issue due to multiple affidavits signed by RSIC personnel. The RSIC was perplexed because these documents contained no new information other than placed in affidavit form. The RSIC still wanted the hearing to go forward to establish a foundation to prevent this issue from recurring in the future. According to news reports, several justices were baffled by the Commission refusing to give Loftis a signed legal document assuring him the State

would not overpay fees. The court noted the RSIC being “in civil” towards Loftis in court documents, as well as referring to him “in a pejorative sense.” The court also questioned why Loftis had not asked for a signed legal document on prior investments, but “all of a sudden (changing) the goal posts (changing) the rules.” Ultimately, the Supreme Court dismissed the petition because it was moot after the STO funded Warburg.

SIG Analysis: The allegation of the specific SP’s final investment contract being negotiated differently from the proposal at a higher fee structure was not accurate. This SP, by its very design, would execute future investments with predictable varying terms based on services provided, which were estimated at two different rates, 50 and 52 bps, in a poorly written proposal memo. Currently, investments under this agreement had average fees of 40 bps, which were lower than both estimates. However, the allegation did highlight the various investment options under the SP were not disclosed in the proposal memo but were set forth in the final investment contract, which may have prevented this misunderstanding in the first place and was further evidence of a poorly written proposal memo.

SP proposal memos to the Commission, based on their nature, request the Commission to approve the SP partner and a general investment strategy, but the Commissioners generally don’t approve future specific investments. Specific SP investment decisions, along with all the details pertaining to fees and terms, are generally left to the discretion of the CIO and the SP partner’s investment team, often involving hundreds of millions of dollars without additional Commission approval. This inherently presents unique challenges to the RSIC staff in communicating how the SP operates and under what conditions, guidelines, and constraints, which clearly were not met within the four corners of the proposal memo in the SP questioned by the Treasurer. However, it appears the intent of this SP investment proposal can be inferred from Commission meeting minutes before the investment and the common sense understanding of how SPs operate, as well as clarified in the final investment contract. Still, when the Chairman approving the SP was surprised the SP invested in a “fund of fund” investment, likely based on the SP purpose was to move away from fund of funds and towards direct hedge fund investments, it demonstrates the lack of clarity in the proposal memo and the investment approval process.

Similar to the previous \$18.3 million dollar fee overstatement issue, this SP issue also seemed to have an elongated pattern of addressing the issue and it is still unresolved. In September 2012, multiple Commissioners questioned this SP’s fee structure and strategy of using fund of funds. Also at that meeting, a proposal by RSIC staff for additional investments in this SP was stopped leading to questions on how much authority had been delegated to the RSIC in this SP. Since that time, the 52 bps issue has been raised, but even the lower 40 bps analysis seems to not satisfy the Treasurer. The SP, by its very design, will fund investments which will have additional management fees, yet there is confusion over the appropriateness, benefits, and possible redundancies of these fees with the SP platform fees. More data requests are pending at RSIC from the Treasurer on this issue. The RSIC staff still believes this SP has obvious merit, but the pursuit of exploiting the SP’s benefits is, as one staff member commented, “*not worth the battle.*” Meanwhile this SP is essentially at a standstill, with this unresolved grey cloud over it as a factor. This SP was designed to integrate RSIC’s hedge fund program to be less costly with greater liquidity and transparency capabilities. The SIG is at a complete loss why this issue can’t be resolved in a timely, evidence based process by Commissioners and staff to see if it is working as designed or not, then decide on a course of action. The disconnect in resolution seems to be the common pattern of RSIC desiring greater specificity on the Treasurer’s issue while the Treasurer complains about lack of data. This is just one more example of delayed action and potential lost opportunity costs caused by relationship and communication issues between the RSIC and the Treasurer.

In addition to the specific SP questioned by the STO, the entire investment approval process was challenged. The investment approval process was not fatally flawed. However, the process had opportunities to be improved which contributed to the crisis circumstances in TA and Warburg. At the 7/19/2012 Commission meeting where the “30 day rule” was approved by the Commission, RSIC staff proposed, which was endorsed by Commission members, to “fill in and flush out some of those details with respect to the implementation.” The obvious flaw in the motion pertained to the lack of specific procedures to resolve any objection by a Commissioner. During interviews, the Chairman provided a common sense analysis that if an objection could not be satisfactorily resolved, it would then require a full Commission meeting to reassess the investment contract. In the 11/8/2012 Commission meeting, the general language of “documented approval” of legal sufficiency was not further specified, and this ambiguity was central in the Warburg crisis. In both the TA and Warburg, the Treasurer’s issue of not having access to a hard copy (TA) and the definition of legal sufficiency (Warburg) were never answered to his satisfaction, yet the Chairman executed both investment contracts. Whether the Chairman thought RSIC’s responses were sufficient despite the Treasurer’s objections, the Treasurer had an “on the record” unresolved objection and there was no policy governing this obvious potentiality. This stalemate then cascaded into a variety of spin-off issues such as the STO refusing to fund, the notion of needing a second vote, and litigation in the State Supreme Court.

A common theme in the STO’s allegations involved weak RCIS processes, and the same was relevant here. Clear processes protect against ambiguity to smooth operations and prevent unnecessary conflict. The TA and Warburg crises were caused by lack of a hard copy document and the definition of “legal sufficiency,” respectively. Both the TA and Warburg investment proposals were unanimously approved by the Commissioners, and there was not a scintilla of a concern on the merits of these investments during their respective crises. What brought both investments to near default which risked losing the investment opportunity along with litigation costs, let alone wasted staff time developing each investment, were two “form” issues. These “form” issues appeared to be simple process issues that could have been easily worked out in a routine business relationship. Herein lies the problem—the Treasurer and the RSIC do not have a “routine” business relationship. Their relationship is best characterized as one of mistrust and contempt.

The current situation between the RSIC and the Treasurer was best summed up with two comments following the Supreme Court hearing broadcasted through the public media:

- Associate Justice Donald W. Beatty, South Carolina Supreme Court: “we don’t appreciate trying to referee kids in a sandbox.”
- Sam Griswold, board member and past President of the State Retirees Association of South Carolina: “we are concerned about...the smooth running of the system. There seems to be a glitch in it. Where the fault is, I don’t know. But it can’t continue like this.”

Finding III-E1: The allegation that higher fees were paid in the identified 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 4/5/2013, 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

Full "Red Flag" Issue: The RSIC staff improperly withheld confidential information from the Treasurer, a fiduciary, and his staff by misapplying South Carolina statutory law and utilizing provisions in investment contracts to drape a cloak of secrecy over its activities.

Data Collection: Prior to Treasurer Loftis' assignment to the Commission in January 2011, the RSIC staff had never experienced the level of detailed requests for investment information or documentation from a Commissioner as they were experiencing from the Treasurer. The RSIC staff's reaction for access to investment contracts containing confidentiality clauses was to take a conservative, legalist view to closely control the Treasurer's access.

The Treasurer initiated his oversight of RSIC investments by asking for information about RSIC processes, due diligence, and valuations of current investments and proposed investments. According to RSIC, the Treasurer has never been denied access to RSIC information. According to the Treasurer, he may not have been denied, but not all of his requests are answered or he has experienced a pattern of dissatisfaction with RSIC's timeliness and quality of its responses. The Treasurer encountered awkward logistics in accessing data, likely the first encounter being required to file a FOIA request for former CIO Borden's travel records. Further, the Treasurer's ability to process this data was limited because initially the RSIC required the Treasurer to only

review confidential documents in the RSIC office space. Eventually, the RSIC staff created a secure Internet portal for all RSIC Commissioners to review confidential investment documentation, but without the ability to print the documents for security reasons, increasing the Treasurer's difficulty in analyzing the documents.

By virtue of the Treasurer's multiple job functions, to include his duties as the State Treasurer, Budget Control Board Member, and RSIC Commissioner, he sought approval for his STO staff to have access to RSIC confidential documents to assist the Treasurer in performing his RSIC oversight. This was met with strong resistance from RSIC legal staff.

An examination of historical investment contract language for access to confidential information determined it was generally broad to include terms like "representatives, affiliates, and advisors" of the investors. Inasmuch as the SCRS was an investor in these agreements, the RSIC could have taken the position that staff of the fiduciaries, trustees, and custodian of funds, were included in this terminology due to their exercising of oversight and approval of the investments. It was the RSIC general counsel's opinion the Treasurer's staff did not meet the definition of a fiduciary as defined by state law and, therefore, could not be provided access to confidential investment information. The state law did not preclude STO staff access. However, according to the RSIC general counsel, the law was silent, which allowed the RSIC to conservatively exclude STO staff based due to a potential liability risk in disclosing confidential information to a non-fiduciary.

At some point, the RSIC recognized the need, or acquiesced to the relentless demands, to allow STO staff access to confidential information. For all new investments, contract language was added to allow access to STO staff, which was never an issue with RSIC's investment partners. Events unfolded that seemed to soften RSIC's position on excluding STO staff. Two separate South Carolina Attorney General (AG) opinions were requested by the RSIC and the Treasurer between September 2011 and April 2012, respectively. Both opinions established the RSIC, State Treasurer, and the BCB are co-fiduciaries in their respective roles as fiduciary, custodian of funds, and trustee and stated, "it is essential that each keeps the other fully informed and that each cooperates fully with their fellow fiduciaries."

Evidence was identified where the RSIC was restricting access to confidential information from STO staff, while at the same time providing access to confidential information to other similar non-commission entities. Examples supporting this observation were:

- The RSIC initiated a Memorandum of Understanding (MOU), dated 10/20/2011, with the SCRS to enable the exchange of confidential information while providing for certain administrative services, information technology services, and accounting functions. The MOU placed no restriction on the type of information to be accessed; recognized the SCRS as a fiduciary and provided for its employees to have access to this information; bound the SCRS and its employees to the same RSIC standards of conduct; and established broad boundaries on the handling of confidential information.
- The RSIC executed an MOU with Clifton Larson Allen (CLA) on 4/26/2012, to examine the RSIC's investment documents as the State Auditor's outside auditor. The MOU provided for full access to RSIC investment information; the retention of confidential information in CLA workpapers; and CLA's use of sub-contractors. The engagement letter recognized CLA as an independent entity by a non-fiduciary of the retirement system (State Auditor's office).
- The RSIC utilized outside legal counsel to assist in the negotiation of investment contracts. This included the printing and distribution of confidential documents for use by the outside counsel. The

engagement letter for outside counsel established an attorney-client relationship, and therefore the confidentiality of documents and access to information was implicit with this relationship.

This all led to RSIC taking steps to attempt to accommodate the Treasurer's request to allow access by STO staff executing non-disclosure agreements (NDA). The initial attempt was a hastily constructed NDA in February 2012, which was not executed by STO staff due to limitations within the NDA. Surprisingly, the RSIC initially requested the Treasurer, a RSIC fiduciary, sign the NDA, but later rescinded that request at the end of the meeting.

This issue spilled out into the public domain on 6/23/2012, with the State newspaper article detailing Treasurer Loftis' efforts to provide more oversight to the retirement system's investments by allowing STO staff to review investment documents. The resistance to granting STO staff access is best summarized by Commissioner Reynolds Williams' own words in this article, "he (Loftis) wants to send his staff in and have them second-guess our staff and look over their shoulder...that's not appropriate." The RSIC Commissioners attempted to resolve this dispute at an Investment Commission meeting on 7/19/2012. A motion was made by the Treasurer to give STO staff full access to confidential investment file material. The motion failed on a vote of three to three.

This issue was brought up in a Budget Control Board meeting on 07/12/2012, when the Treasurer remarked that he is asked to digest significant contracts requiring the experience of a lawyer or someone with a securities license. The BCB asked the Commission to recommend in writing areas which needed to be addressed legislatively to resolve this issue, so that it is in the statute, and not just in an MOU.

At present, the RSIC has a new NDA in draft form. While it was represented to the SIG the current draft NDA would give STO staff full access to investment documentation, in reality the RSIC continues to exert limitations on the type of information that would be made available. RSIC senior management confirmed this is an "80% solution", which would allow access but aid the RSIC in controlling the repetitive requests by STO staff. From the SIG's observations, it is only two pages, but it has an overly complex appearance. It is still unacceptable to the STO.

During a 5/23/2013, Investment Commission meeting, the RSIC Chief Operating Officer (COO) stated the intent of the draft NDA currently under consideration with the Treasurer's office is to be signed only once by the named principal to give confidential information to designated staff. It is intended to cover all prior investments and proposed future approved investments of the Commission. The appendices listing the covered documents, while not every piece of paper RSIC staff touched relative to the investment, is more than sufficient for a top-level fiduciary to become comfortable with issues of custody, legal sufficiency, and be able to make the determination the proposed investment was approved and in agreement with the final contracts. The COO expressed his desire to discuss this with the Treasurer and his staff to ensure that the NDA wording reflects this intent.

This entire, disjointed, elongated, and confusing confidential information access issue can be illustrated by RSIC's initiative to partially remedy this issue in July 2012 by including language in each new investment authorizing STO staff access to these confidential documents. In June 2013, the STO was aware RSIC was working on this initiative, but unaware it had been fully operational for nearly a year. RSIC then promptly refuted this STO assertion by providing documentation previously notifying the STO on two occasions. Nevertheless, the first attempt to use this new confidential information access technique after the STO became aware of its existence failed. An investment was in the "30 day rule" period for the Treasurer's review, but the

STO staff was precluded from viewing the investment documentation because the access becomes effective only upon the executing the contract. The hard working staff trying to fix this issue called it a “catch-22,” a term describing a paradoxical situation and an appropriate description of this issue. The RSIC made special arrangements to address this issue, but only on a one time basis. As of the date of this report, this NDA issue is still unresolved.

As a mechanism to understand the impact of the Treasurer’s data requests, for both confidential and non-confidential information, CIO Harper initiated an information request tracking system in February 2012, which tracked all RSIC Commissioner requests to the RSIC staff. From 2/3/2012 through 5/2/2013, the RSIC staff fielded ninety-three information requests from Commissioners. Ninety (97%) of these requests originated from the Treasurer’s office; 44 requests attributed to the Treasurer and 46 from his staff.

Despite the Treasurer’s steady assertions of lacking access to information, the RSIC strenuously argued he has significant access as demonstrated the volume of requests and the inordinate amount of staff time dedicated to provide data to the Treasurer. A senior RSIC manager estimated 30-40% of his core administrative staff’s time is absorbed by dealing with information requests or Treasurer fiduciary issues. The RSIC staff had the universal perception the Treasurer’s intent was to find fault rather than understand for the betterment of the Commission or fulfill his oversight responsibilities. This information access issue has escalated tensions and perceptions where staff fears ridicule, reputation loss, and even job loss with every response to the Treasurer, which inherently slows processing time and contributes to a less than robust exchange of information. The staff’s concerns were illustrated in initiating peer reviews of each other’s work prior to responding to the Treasurer. One new staff member, who was well respected by both co-workers and the STO, advised he would not have come to work at the RSIC if he was aware of the work environment caused by the communication dysfunction between the RSIC and the STO.

The RSIC staff identified the common theme that there seems to be no satisfying the Treasurer and his staff. Issues tend to require repeated explanations and are received with a high level of skepticism leading to the next wave of questions, sometimes on the exact same topic previously provided. At the Commissioner level, most every Commissioner reported they have attempted to individually engage the Treasurer as the friction has increased over the past two years with little success. The Commissioners universally asserted that the Treasurer’s lack of specialized financial experience and expertise to understand the RSIC was a contributing factor to the communication dysfunction. There was also a common theme among Commissioners that the Treasurer’s intense scrutiny and criticism benefits him politically.

As much as the RSIC feels victimized by the Treasurer’s inquiries, the Treasurer and his staff feel the same as set forth in the “red flag” complaint, *“STO has tried to follow-up on many of these red flags; however, key personnel at the RSIC often have stopped STO’s inquiries by (a) wrongfully establishing and maintaining a cloak of secrecy around the RSIC and its activities... or (b) by merely ignoring STO’s inquiries, requests, or statements.”* As much as the RSIC described the STO as the aggressor, the STO portrays itself as equally frustrated in an uphill battle using its own limited resources to squeeze information from RSIC. The common STO frustration is observing a pattern of shifting answers on the same issue, and receiving data not on point with the request. Many of the STO’s data requests pertain to gaps in RSIC’s operational policies, procedures, and execution. RSIC seems slow to address or provide information about these gaps which only fuels the STO’s suspicions.

One of the few areas where the Treasurer and RSIC have complete agreement is their common assertion that it is very difficult to “pin down” the other in terms of specificity on issues and facts. Both sides are equally

skeptical of each other's motives and data. It appears to be more of an adversarial, litigation environment than a productive business workplace. Interviews with a credible third-party corroborate the current tension between the RSIC staff and the STO and its corrosive disruption to RSIC investment operations.

According to RSIC, the tangible impact that this communication dysfunction and, even worse, the personal animosity are having a material impact on RSIC operations as illustrated by these examples:

- RSIC invested \$1.7 billion in a strategic partnership, but has delayed investing additional funds for fear of likely public criticism by the Treasurer, even though the Commission approved a targeted investment of \$3 billion. This strategic partnership was designed to reduce external management fees and retain more liquidity and transparency with AIs through this platform service.
- RSIC's plan to create an internal investment management team was tabled, again, for fear of likely public criticism by the Treasurer. Conceptually, the creation of an internal investment management team would save an estimated \$89 million in net external management fees over a five year period.
- An expert with unique insight into RSIC's operations projected fewer staff investment proposals for fear of professional ridicule by the Treasurer, as well as less time to focus on investments due to time expended meeting the Treasurer and his staff's data requests. These distractions caused by the STO are *"dysfunctional and destructive... [and] getting to the point it is going to cost the system."*
- The TA and Warburg crises exemplify the mistrust in this relationship and its impact on RSIC's operations, let alone the reputation damage to itself, the South Carolina Retirement System, and the South Carolina State Government.
- Staff and Commissioner recruitment and retention have and will continue to be impacted by the atmospherics caused between RSIC and STO.

The STO argues these missed opportunities may actually be positive. The lack of initiatives "may be a blessing" that serves to protect assets of the trust until RSIC begins to operate with proven, effective due diligence and other controls. Taking these two positions together, it paints a picture of operational decisions not being made in an evidence based, intentional manner, but rather by default from a type of gridlock situation caused by an environment of distrust and avoidance of action for fear of starting another cycle of unhealthy scrutiny and criticism.

SIG Analysis: The OIG did not uncover a conspiracy within the RSIC to nefariously or arbitrarily conceal information. The RSIC management deferred information disclosure decisions to its legal staff. Giving the legal staff the benefit of the doubt, its initial restrictive actions on controlling confidential investment information with the Treasurer and his staff could be a result of a conservative legal analysis. This legalistic approach first manifested in awkward logistics for the Treasurer to access confidential information. The Treasurer's frustration, as well as business case for enhanced access, is exhibited in an email regarding the TA investment, *"the investment totals 564 pages in 15 separate documents. The Investment Commission makes the unreasonable and possibly illegal demand that I alone must read (online without the ability to print), understand and verify this information personally, without the assistance of staff attorneys, bankers or accountants."*

The Treasurer's data needs were driven by legitimate concerns of RSIC's investment strategy yielding investment returns over the past five years continually trailing its peer group along with a high management fee structure. The Treasurer also had concerns about inadequate operational due diligence and management control capabilities based on consultant reports and former CIO Borden's leadership style. Given the reality of the statutory duties of the Treasurer to lead his agency and simultaneously serve as a BCB member and RSIC fiduciary, he requested his staff have access to confidential information to assist and leverage his ability to carry out his RSIC fiduciary oversight duty. This request was denied. The RSIC excluded the Treasurer's staff access based on a narrow legal interpretation based on the "silence" in the law, despite clear contract language that could easily be construed as including the Treasurer's staff for access.

Soon, it was clear other non-fiduciaries and non-RSIC parties had access to confidential information operating under basic RSIC non-disclosure agreements. Additionally, the RSIC staff had a continued pattern of suggesting the lack of clarity in which role the Treasurer (RSIC fiduciary; BCB trustee; or STO custodian) was asking for information contributed to adding confusion to this information access issue. From the SIG's analysis, this was a moot point; there should have been no confusion. The Treasurer was always a RCIS commissioner every minute of every day which gave him complete access to RSIC information, as well as all of his roles were considered co-fiduciaries as set forth in the AG opinion obtained by RSIC.

As the Treasurer's frustration mounted, it only ramped up the Treasurer's information requests to RSIC staff in volume and tone. The Treasurer's intense style certainly contributed to further strain the relationship. The Treasurer was further frustrated by a level of dissatisfaction with RSIC's timeliness and quality of its responses, while RSIC staff's fear inherently slowed their data processing responses and may have contributed to a less than robust exchange of information.

As the legal basis for limiting disclosure withered, or as RSIC acquiesced to the relentless pressure, it incrementally pursued a course of opening the confidential information aperture to a current offer of full access for the STO staff with caveats on control and certain documents. Their reason for still demanding some modicum of control was not based on the law, but rather fears of the Treasurer and his staff abusing full access which would further disrupt the workplace.

The Treasurer responded to the RSIC's limiting approach to information by what we all should expect of any fiduciary—go over it, go around it, go under it, but do not take "no" for an answer. Lessons learned from the business crises of the past decade clearly demonstrate a common theme of boards of directors (fiduciaries) failing to act on red flag suspicions. The Treasurer had an affirmative responsibility to act on his suspicions, and anything short of full unfettered access in the most efficient and effective manner is not acceptable. If the Treasurer abused this full access, then the Commission would have a basis to restrict, rather than start with a restrictive attitude towards a fiduciary.

The RSIC's legal model of a restrictive NDA controlling the alleged negative impact on operations by the Treasurer's alleged unreasonable information requests only leads to friction, allegations, and counter-allegations. Every inquiry is adjudicated on a case-by-case basis with no due process for denials or perceived deficiency in responses. The SIG suggests a leadership model accomplishes the same objective, but in a transparent process where the Commission has to proactively set forth with specificity the parameters defining "reasonable" and "unreasonable" information requests and a recurring mechanism for appeal and adjudication of exceptions. This is just an application of the fundamental issue lacking in many of the "red flag" issues—process protects.

The SIG noted throughout its review a clear pattern of routine business issues and concerns between the STO and the RSIC being overly complicated with fragmented information exchange through emails and spreadsheets over inordinate time frames. Routine issues seem to circulate for inordinate amount of time, and often never resolving, when an ordinary face to face meeting with complete data would have resolved or crystallized these issues. It was as each side was always in a posturing position involved in litigation or a negotiation, rather than a business focus on understanding issues to make better decisions.

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.

IV. Root Cause Analysis of "Red Flag" Indicators:

The six "red flag" issues examined are symptoms of larger issues. Analysis of root causes identified three primary issues. First, the Treasurer has reservations about RSIC's investment strategy and corresponding results, particularly with the emphasis on AIs. Second, there are concerns about RSIC's operational infrastructure's adequacy to support the professional management of a \$25 billion asset portfolio. Both of these issues are substantive and logical concerns for any person or entity with an interest in the RSIC and the SCRS succeeding, particularly those most responsible—RSIC Commissioners. Addressing both of these issues requires an assessment, which inherently requires data, analysis, and communication among interested parties to draw conclusions, develop options, and then make decisions. It is this data and communication process, the

third component in the root cause analysis, which has become so dysfunctional that it clouds focus on the substantive issues of assessing RSIC's infrastructure and investment strategy.

A. Dysfunctional Communications:

To illustrate the communication dysfunction, during interviews at the STO and the RSIC, each independently used the exact same encounter to illustrate how each was victimized by a personal slight and the other party was unreasonable and unprofessional. It is a hyper-sensitive environment where routine business involving facts and dialogue have been replaced by perceptions, skepticism, and interactions resembling the adversarial system found in a court room. Management reviews, such as this aspect of the report, normally describe many of such encounters to illustrate conditions "on the ground" to facilitate the decision makers' understanding. The list of alleged wrongs, to include public falsehoods, personal attacks, and assaults on professional reputations, from both sides was, sadly, a long list. Rather than using examples which may be too inflammatory, a comparison may prove beneficial. The Inspector General, as well as his two principal investigators, has never observed a relationship between organizations that is more polarized, distrusting, skeptical, and held each other in such high contempt as the relationship between the RSIC and the STO.

Although the access to information issue seems to be at the center of this dysfunction along with differences on assessing investment strategy and infrastructure, many other factors have seeped into this dysfunctional relationship to have shaped the current situation which is seemingly irreconcilable. This relationship has clearly entered into a stage where it is personal and underpinned as much by alleged, perceived, or real ethical and moral lapses of the other party as by business differences. The only thing for certain is the current state of the relationship. Even with full information access, the two year battle scars are so thick that it will be difficult to restore the lost trust, which limits access to the most important form of information---open, candid, and robust dialogue to facilitate understanding. The majority of interviews depicted the relationship between the STO and RSIC as so damaged that restoration of trust as highly problematic. This review is unique in that both parties desire to elevate this issue to a higher authority, in this case the BCB, to help with a resolution, rather than the normal response in such reviews where parties tend to downplay the leadership issues hoping to avoid potentially awkward scrutiny from a higher authority.

There is no winner, and everyone involved has liability for the current state. We can debate "who threw the first punch" and a relationship expert, which is not the SIG, may be able to parse proportional responsibility for the current state of affairs. The obvious harm is on the people involved in terms of stress, potential turnover, and morale. The less obvious harm can be measured in real dollars through opportunities lost or delayed having a material impact on operations as set forth in this report. Both the TA and Warburg crises exemplified the impact of this dysfunctional relationship on operations. Without a doubt, the harm also involves the South Carolina Retirement System beneficiaries and the reputation of the RSIC and the South Carolina State Government.

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 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:

Organizational control processes are designed to add both efficiency to operations through standardization and effectiveness through establishing a control environment to support better decisions and lower risks of negative events. After receiving broader authority in selecting investments, the RSIC used its limited staff in FY 2008 to invest \$8 billion (31% of portfolio) in AIs in a 12 month period. Certainly, every new operation has a tendency for its operational activity to get out ahead of its operational control processes, which was the case at RSIC. This “fast diversification” was a criticism by the Treasurer inasmuch as the RSIC did not have adequate systems to manage these investments, which may have impacted optimizing the selection of external managers, contract negotiations, and on-going due diligence to identify issues early in these complex investments.

To what extent better procedures and controls would have enhanced returns will never be known, and it may be difficult to quantify the benefits to the portfolio, asserted by RSIC, for rapidly diversifying the \$25 billion portfolio in FY 2008. However, as one expert astutely described the need for procedures when investing billions of dollars, “process protects.” The lack of procedures and operational control processes heightens both the risk of operational error, as well as undermines management’s credibility in prudently executing its mission. Hindsight is always 20/20, but fiduciary responsibilities and public expectations of maintaining an adequate control environment for a \$25 billion public pension fund should always be a prime objective, not something incrementally addressed and under prioritized. Arguments have been made this development was inhibited by conservative RSIC spending in 2008 and 2009 when other state agencies were laying off personnel or by poor execution, as asserted by the STO, evidenced by unexpended budgets averaging over a million dollars in FY 2008 – 2011. What is clear--infrastructure was just not organizationally prioritized until late 2011.

The weakness in the control environment was often acknowledged by RSIC management, such as former CIO Borden stated in September 2010, *“the need to build out robust audit and risk functions is critical for a portfolio that is growing in sophistication and detail.”* He reported that a staff of 10 investment professionals is not appropriate for a \$24 billion plan.

In September 2011, Deloitte consultants conducted a strategic risk assessment of the RSIC’s operations. The Commission realized it had infrastructure and operations needing improvement, so it self-initiated this Deloitte review to solidify a roadmap for improvement. Within RSIC’s operations, eleven inherent risks of managing plan assets were assessed. Seven were considered high risk, and the remaining four were medium risk. Priority recommendations include improving internal technology to support operations; solidify basic operating policies and employee roles & responsibilities; plan to develop personnel; expand and implement due diligence practices; and develop a compliance function. In short, the RSIC needed to solidify the fundamentals of basic operational management.

At the September 2011 RSIC Board meeting, former CIO Borden commented on the deficiencies in this Deloitte report stating, *“while the Commission was no longer in the startup stage, there was still build-out occurring. He stated that when the Commission was formed in 2005, the main priority was diversifying the portfolio.”*

In August 2012, Deloitte conducted a second report assessing three areas: external manager due diligence, investment valuation, and cross trades. Deloitte determined the RSIC made progress towards enhancing and

improving its due diligence processes, but employees did not consistently follow RSIC's own established procedures. Employees reported there were insufficient resources, to include technology, to meet RSIC's own guidelines, but on-going due diligence was conducted and was just not formally documented. The lack of these initial and on-going due diligence controls correspondingly undermined supporting its valuation of external managers.

Since the 2011 Deloitte report, the RSIC has taken measurable steps to address its operational deficiencies, as demonstrated by its monitoring mechanism, "Deloitte Risk Assessment Progress Dashboard" (attachment B) to set staff expectations and allow the Commission to monitor progress. The RSIC increased its staff, particularly noting the hiring of an internal auditor, compliance officer, and a Chief Operating Officer who will focus on the operational processes supporting the investment staff. Commissioner interviews noted improvement, and the new RSIC consultant, with wide investment operation experience, described the operational environment as satisfactory with opportunities to further develop. Even the Treasurer reported in the media that RSIC is making progress, *"the investment commission is renegotiating fees (and) eliminating costly investment structures. We're altering our investment plans so we rely more on passive management and less on active management. And we're going to have greater and more detailed reporting for 2013 than we did (in) 2012."*

An overarching theme in the STO's allegations is the concern with RSIC employees controlling \$25 billion and Wall Street type firms potentially enticing RSIC employees with perks or self-interest in business transactions. Despite the six issues examined did not reveal any wrongdoing, history has demonstrated this as an investment industry risk. The best mechanism to mitigate this risk is through institutional internal controls and maximum transparency. Certainly, RSIC's control environment has been a repeated theme as well as transparency with AI fees and expenses. These conditions don't equate to wrongdoing, but RSIC's continued improvement in these issues provides both deterrent controls and increased assurance of operational integrity. This will contribute to soaking up STO "red flag" suspicions, and increase the likelihood of uncovering wrongdoing if it exists.

The deficient operational control processes alarmed the Treasurer, and rightfully so given the September 2011 Deloitte Risk Review coupled with his fiduciary responsibility. Certainly, on paper, the RSIC has been improved since 2011 in policies, procedures, and internal controls. The RSIC asserted that the 2011 Deloitte recommendations will all be addressed by June 2013. Fortuitously, when PEBA was established in July 2012, the legislation also mandated an annual fiduciary audit of the RSIC and PEBA. A fiduciary audit tests policies, procedures, and controls against investment industry best practices to identify strengths and areas for improvement. The first fiduciary audit is statutorily required to take place in FY14 (7/1/13-6/30/14). The Inspector General will coordinate selection of the auditor. This independent examination of the RSIC operations by subject matter experts will bring clarity to this issue, and focus on an ultimate resolution.

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:

The heart of this visceral debate between the RSIC and the Treasurer over investment strategy centers on four variables: management fees; investment return; investment risk; and AI (private equity, hedge funds, commodities, and real estate). Basic facts relevant to these four variables are:

- As a percentage of assets managed (\$25 billion), RSIC management fee expenses (\$296 million in FY 12) are higher than published public fund averages due to greater asset allocations to AIs, more active investing (less passive), and higher use of external managers due to internal staff limitations;
- Over the past five years, the RSIC's investment returns ranked (5th percentile-high; 95th percentile-low) 77th among its peer group at a 3.9% annual return (6.8% high; 4.7% median; and 2.7% low);
- Investment risk is a factor in producing investment return. According to RSIC's consultant, RSIC's volatility, a key variable in risk, has been much lower than peers over the past five years; and
- AIs provide attractive rates of return and add diversification to RSIC's portfolio, but due to AI's complexity and unique risks, the RSIC must have adequate due diligence capabilities to prudently select and manage AIs.

These basic mathematical and definitional facts are not at issue, and the areas of agreement between the RSIC and the Treasurer on these facts are greater than either would believe. Their disagreement surfaces in their conclusions drawn from these simple, common facts.

The RSIC asserts the data is consistent with its investment strategy. Five years ago, the RSIC intentionally diversified its portfolio towards an emphasis in AIs (40%) and less on traditional stocks (public equity) and bonds (public income). Emphasis on AIs would certainly require higher management fee expense than traditional pension portfolios, but the AI projected benefits were deemed to exceed these investment costs. The RSIC portfolio was designed to provide higher returns in the long-run and less risk of being impacted by the major fluctuations in the stock market. Since early 2009, the stock market has dramatically fluctuated, primarily in an escalating upward direction (bull market) with a 120% increase. Peer plans, which more closely resembled traditional fund plans with a higher percentage of stocks, would inherently outperform the RSIC in this current bull market. The RSIC portfolio's design is more defensive to protect the portfolio when stock prices fall (bear market) as compared to peers having a higher concentrations of traditional stock. The current strategy emphasizing AIs, based on economic forecasts, will provide the best option to maximize plan returns over the long-term.

RSIC asserts its portfolio has a lower risk profile as compared to its peers over the past five years, as confirmed by its consultant. RSIC measures this with the financial metric known as the Ann Sharpe Ratio, which generally measures the ratio of returns to investment volatility, a key variable in overall risk. RSIC's Sharpe ratio over the past five years was 0.34, which, according to their consultant, compared favorably to its internal benchmark's ratio of 0.26. This metric's value appears to be best when comparing similar investments or portfolios—the higher the better--rather than the ratio having a static meaning of good or bad.

Even though the RSIC has trailed its peers for five years, one expert commented, ‘investment decisions can’t be made looking in the rear view mirror, but rather by looking forward through forecasts.’ Each year, the RSIC reassesses its strategy with updated forecasts from its portfolio consultant, to include its recently hired new consultant, and its strategy is reaffirmed annually by industry experts. RSIC also noted AIs tend to have higher returns after their initial five years, so returns should increase, and when the stock market cycle invariably has a downward correction, RSIC’s strategy should outperform its peers.

The RSIC shies away from peer performance comparisons due to peer plans having different investment strategies. RSIC’s avoidance of using peer comparison for any single year comparison based on potentially different strategies has merit. However, over the medium and long term, peer comparisons certainly have value if for no other reason than a litmus test to cause plan introspection for deviations from peers. The RSIC’s primary objective, set by statute, is to achieve a long-term average rate of return of 7.5%, along with sufficient liquidity to meet its annual obligations to beneficiaries. Thus, its strategy has a long-term horizon balancing return and risk, rather than “winning” a race each year to beat peer public pension funds which would require an unhealthy emphasis on higher levels of risk.

The RSIC prefers assessing its performance by establishing internal income benchmarks for each of its portfolio asset classes, which tend to be passive index funds composed of similar assets. It should be noted that comparing these internal income benchmarks to RSIC’s peer group over the past five years, RSIC benchmarks ranked (5th percentile-high; 95th percentile-low) 95th, the lowest percentile, with an annual return of 2.7% (see Appendix C).

The Treasurer’s optic is based on a pattern over the past five years of the RSIC’s annual investment returns continually trailing its peer group. An exacerbating factor is RSIC paying higher management fees, compared to peers, yet their investment returns still trail their peers. The Treasurer is also less optimistic that RSIC’s strategy will provide the defensive posture to perform better than peers in a falling stock market. Additionally, the Treasurer has concerns the RSIC has inadequate operational capabilities and controls to manage the complex AIs which could impact investment returns, such as the valuation of AIs in existence today. Operational capabilities certainly impact investment returns, but the “driver” in RSIC’s performance trailing its peers is its long-term investment strategy allocating more to AIs and less to traditional stocks in the recent predominantly bull market environment.

Without a doubt, questioning an investment strategy which has trailed peer plans for five years is a legitimate debate. Then how has this legitimate debate devolved into contributing to the current dysfunctional communication environment? Based on media accounts, each side accuses the other of disingenuously portraying this issue in the media without the proper context as illustrated by the following:

- The FY 2012 (7/1/11-6/30/12) RSIC Annual Investment Report contained a normal cover letter from Chairman Gillespie and CIO Harper, dated 11/30/12, reporting investment returns of 0.40%. A second cover letter, which was called an addendum to the report, was authored on 1/9/13 by incoming FY 2013 Chairman Reynolds and CIO Harper reporting calendar 2012 returns of 11.5% with no mention of the FY 12 returns of 0.40%. A fellow Commissioner, not the Treasurer, disagreed with this letter because it was not presented in context with comparative data expected within the financial industry.

In mid February 2013, the Treasurer identified this issue and reported in the media, *“Again, the South Carolina Investment Commission presented financial information to the public without proper context ...*

the Commission failed to report that their performance for the calendar year (11.5%) placed them in the bottom 35% of large pension plans ... I asked the Investment Commission to stop using misleading information to hide its poor performance and yet they continue to do so.” The Treasurer further said the numbers were “*deceptive,*” adding the Retirement System Investment Commission, which reported the numbers, “*lacks a moral core.*”

On February 28, 2013, the Commission publically censured the Treasurer. The letter read, “*Commission hereby condemns and censures the South Carolina State Treasurer for engaging in false, misleading, and deceitful rhetoric.*”

Review of the prior four FY RSIC Annual Investment Reports noted this second cover letter covering the unaudited calendar year results has never previously occurred, which gives the appearance this second letter was to take advantage of a fortuitously sharp increase in the stock market in the second half of the calendar year 2012, which was outside of the FY 12 reporting period (7/1/11-6/30/12) having only a 0.40% return. Additionally, FYs 08, 09, and 10 reports contained comparison data with peer plans and internal benchmarks, but comparative data with peers was discontinued in favor of only internal benchmarks in FYs 11 and 12 reports.

- The Treasurer is often quoted in the media with the common theme, “*we pay too much in fees and we earn too little. I love AIs. I love Wall Street. I don’t mind paying fees. But I want returns.*” In this same article, the RSIC spokesman responds, “*we (RSIC) view this as a long-horizon strategy for a fund that has to last a long time. There will be fluctuations, but the commission believes that it has the appropriate long-term plan.*” A fellow RSIC Commissioner contributed another perspective to the media, “*it is too early to tell whether the hedge-fund, private-equity and other nontraditional investment strategies are working, because they often involve less-liquid assets that can take years to produce big payoffs.*” These two RSIC perspectives portray the Treasurer looking at RSIC results in a short-term, myopic vacuum and not adding the obvious perspective that the RSIC strategy should, based on its defensive design, trail peers in the current bull market but perform better than peers in a down (bear) market.

Each side has a rational basis for their position, but bringing both perspectives into the same conversation without a combative tone for the public to understand has fallen far short. Very smart people in government close to this situation are scratching their heads as to understanding the issues, the contentiousness, and a way forward.

The RSIC has to do better than continue the dysfunctional communication blurring the public’s understanding of its results and strategy, and just wait for the next bear market of falling stock prices to see if the RSIC strategy works as designed. The RSIC needs to align all perspectives into a professional evidenced based model of leading a \$25 billion pension fund, where metrics can be agreed upon to frame divergent opinions into a coherent discussion on strategies and returns. Establish agreed upon metrics, including peer comparisons (by total and by asset class; by current year and over time) and more robust, challenging internal benchmarks. Then add analysis of balanced pro & con positions written in language understandable to the non-financial expert. We don’t have to wait until the next bear market to test our strategy; we should be able to test our strategy every year in an evidenced based rational and healthy discussion and debate, and then a decision to stay the course or modify without the conflict and the confusing discourse to the beneficiaries and the public.

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.

V. Way Forward:

The Treasurer’s fiduciary interest about operational control processes and the investment strategy was justified. The RSIC’s legally conservative approach to disseminating confidential information to the Treasurer only exacerbated his suspicions. This, in turn, only ramped up the Treasurer’s information requests on RSIC staff which furthered strained the relationship. When one side feels like it is under constant audit assault looking to find fault and the other side feels like his fiduciary efforts are thwarted at every turn, it is a recipe for a broken trust relationship. A business consultant noted, *“Trust is more than a nice-to-have, soft, social virtue; it is a hard-edged economic driver. High trust increases speed and reduces cost in all relationships, interactions, and transactions. Take away trust, and everything grinds to a halt.”* This is where the RSIC is at today; a cautious, tepid, and defensive work environment where initiative and creativity are dulled and even the smallest issue between the RSIC and the STO takes an inordinate amount of time to deal with, often never quite resolving, and all having an impact on operations.

This intense RSIC and STO relationship, despite the increasing negativity and dysfunction, did have some “silver lining” benefit. Over the past two years, this conflict has encouraged RSIC introspection on both operational infrastructure and AI portfolio, in terms of portfolio concentration and fee structure, which have yielded some benefits. However, this conflict has clearly entered into a counter-productive cycle where it has created workplace atmospherics so toxic that it is increasingly undermining RSIC’s energy and focus on its core mission.

The SIG conducted a limited review of six specific issues, and certainly can’t provide assurance of some bad behavior since the inception of the RSIC in 2005. The SIG can provide assurance through a review of all available documents and interviews pertinent to the original complaint coupled with interviews of every executive manager involved, as well as a sizable percent of the RSIC staff, that no criminal conduct or wrongdoing was uncovered in the six issues reviewed. On the contrary, every interview, both the STO and the RSIC, demonstrated committed, passionate employees desperately wanting to focus on the mission of making the RCIS and SCRS successful.

Trust has to be re-established at the Commission through direct intervention by the Budget Control Board, which has a variety of options. The rhetoric, unhealthy criticism, fault finding tendencies, and a pattern of personal slights must end, and the parties need to solve problems, big and small, while face-to-face in the same room and not through email or the media. All parties must step back and just let go of the past, and if not, move on to another endeavor. Then, the RSIC has to project transparency in all its actions and reporting to avoid

misperceptions. Further, it must develop a reporting mechanism, which describes in clear, unambiguous terms RSIC's strategy and execution results integrating peer results and robust benchmarks.