

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

November 8, 2018



# Overview

- Funston Advisory Services LLC (FAS) was selected by the South Carolina Office of the State Auditor (OSA) to conduct the 2018 South Carolina Retirement System Investment Commission (RSIC) fiduciary performance audit.
  - FAS also completed the 2014 fiduciary performance audit of RSIC for the South Carolina State Inspector General.
- The primary purpose of the 2018 audit is to evaluate the progress made in implementing the recommendations resulting from the 2014 fiduciary performance audit of RSIC.
  - This fiduciary performance audit began in May 2018. The 2018 FAS team was substantially the same as the 2014 team.
- OSA also requested the review:
  - Identify any areas of weakness in current operational policies and practices.
  - Prioritize recommended improvements by significance and urgency and, where feasible, include an analysis of potential costs or benefits associated with implementation.

# Overall Assessment of Progress

## In 2014

- RSIC's infrastructure had not kept pace with its complex investment strategies (e.g., private equity, strategic partnerships, etc.)
- The Commissioners were involved in performing investment operations such as due diligence to the detriment of a more strategic focus.
- Severe frictions existed within and between the Commission and the Treasurer's Office amid accusations of Commission malfeasance.
- The legislative framework governing RSIC was highly fragmented with multiple, unclear authorities, responsibilities and accountabilities.
- In sum, RSIC was reactive, destabilized, and in crisis. Staff were demoralized. Media coverage was often hostile, and beneficiaries and members were anxious. The General Assembly was deeply concerned.

# Overall Assessment of Progress

## Our 2014 fiduciary performance audit

- 126 recommendations for improvement.
- Five improvement themes:
  1. Reset Commissioners' focus on strategy and oversight.
  2. Improve assurance and independent reassurance to build trust and confidence.
  3. Align fiduciary duties and responsibilities.
  4. Build capabilities across the organization (including HR, IT, Accounting, etc.).
  5. Improve the custodial relationships.
- Significant progress has been made
  - 110 of our recommendations fully implemented.
  - 9 are substantially implemented.
  - Of the remaining 7 which have not been implemented, five are under the control of RSIC and two still require action by the General Assembly.

# Overall Assessment of Progress

## **Very impressive progress**

- From a very troubled and difficult situation, RSIC is now stable, has strong leadership, effective governance, and capable staff and operations.
- As recommended in 2014, the Commission created and filled a new CEO position in 2015.
- The CEO has been instrumental in leading the organization forward with clear direction and purpose.
- The CEO has also been able to build effective relationships with the General Assembly and the Treasurer's Office.

# 1. Reset Commissioners' focus on strategy and oversight

## Significant progress

- Commissioners are now focused more on oversight and the longer-term strategic challenges of RSIC and much less on the day-to-day investment execution processes
- The Commission created the Human Resources and Compensation Committee (HRCC) and Audit and Enterprise Risk Management Committee (AERMC) and expanded Charters to reflect broader oversight authorities.
- The Commission completes an annual self-assessment process to identify areas of improvement.
- Most investment manager selection decisions were delegated to the CIO in October 2017.
- Relationships between Commissioners and stakeholders have improved significantly.

## 2. Improve assurance and independent reassurance to build trust and confidence

### Significant progress

- The PEBA auditor, CliftonLarsonAllen, conducts annual Agreed Upon Procedures (AUP) and reports to the AERMC.
  - Typically, these have focused on due diligence procedures and investment valuations, but have also addressed other areas, as appropriate.
- The roles and responsibilities in the Internal Investment Committee charter have been strengthened, detailed and clarified.
  - The charter was most recently updated and approved in May 2018.
- RSIC now participates in CEM's annual peer investment performance and cost benchmarking.

## 2. Improve assurance and independent reassurance to build trust and confidence (cont'd)

### **Some progress but still needs improvement**

- ERM, Internal Audit, and Compliance have been combined into a single position (Director of Enterprise Risk Management and Compliance). The position is currently vacant.
  - Internal audit activities are being outsourced and are also under the direction of that combined position.
  - Currently, there is no functioning ERM program although significant management attention is given to identifying and managing risk and there is very good tone at the top. Despite the absence of this position, all compliance responsibilities are being maintained and an audit plan is being followed.
- Although the Commission had approved an enterprise risk management (ERM) program in 2014, and the AERMC charter includes responsibility for oversight of the ERM program, very little progress has been made.
  - This is due, in part, to frequent turnover in the Director of ERM position and the complexity of the proposed ERM process.

## 3. Align fiduciary duties & responsibilities

### Very Significant Progress

- Eight recommendations were made to the General Assembly in 2014. Six were incorporated into legislation in 2017
- These improvements have been a major contributor to the ability of RSIC to continue to make strides in its governance and performance.
  - Fragmentation of fiduciary responsibilities has been significantly reduced, including removal of the SFAA as a retirement system fiduciary.
  - The General Assembly will now receive a recommendation every four years from PEBA, in consultation with RSIC and the system actuary, for the assumed annual rate of return.
  - The reform legislation also codified the CEO position – implemented by RSIC in 2015.
  - RSIC is now allowed to engage attorneys in consultation with the Attorney General.
  - The Commissioner qualification criteria were modified to recognize relevant experience in lieu of specific credentials, and the size of the Commission was expanded with a seventh voting member.

## 3. Align fiduciary duties & responsibilities (cont'd)

### **Some progress but still needs improvement**

- We continue to recommend the General Assembly:
  - delegate authority to the Commission for operational budgetary control, the setting of staff compensation and performance incentives, and
  - provide an exemption to the State procurement policy for investment management systems.

## 4. Organizational Capability Development

### Significant Progress

- A new hiring and interviewing process, onboarding plan for new employees, core competency development, and training were implemented in 2014.
- The HR function has been effective in supporting organizational development. However, the succession plan is out of date, which is a critical gap.
- At the time of the 2014 review, RSIC had planned to begin a program to internally manage some public investments.
  - This would have required significant new capabilities in trading systems and staffing as well as governance and oversight.
  - Since that time, RSIC has revised its plans, and has no immediate intention of managing assets internally and is focused on an externally-managed portfolio.
  - As a result, many of the critical internal infrastructure needs identified in 2014 have been mitigated.

## 4. Organizational Capability Development

### Significant Progress

- RSIC has made significant upgrades to its support capabilities through:
  - The hiring of an investment administrator in 2014.
  - A risk analytics system has been acquired.
  - A document storage and management system has been implemented.
- RSIC formed an IT Steering Committee in 2016 which provides oversight and governance for IT-related needs of the organization.
- RSIC is considering significant changes and upgrades to its risk and workflow capabilities. The Steering Group is a key driver of the process.
- RSIC has also formed a cross-functional Business Internal Investment Committee which meets quarterly and is intended to ensure effective communication of business initiatives to and from the Investment Office.

## 4. Organizational Capability Development

### Some Progress

- RSIC has not developed an overall 3- to 5-year infrastructure plan as recommended in the 2014 review.
  - However, in the key initiatives developed by the Commission through their most recent self-assessment process, a focus on more comprehensive organizational strategic planning for resourcing, personnel, infrastructure, risk management, systems and policy was identified as a goal.
  - While this has become a lower priority due to the decision not to pursue internal asset management, it will still be a helpful step which could guide the overall capability development for the future.

## 5. Improve the Custodial Relationship

### Significant Progress

- The new statute passed by the General Assembly in 2017 designated the PEBA Board as the custodian of the trust's assets and made RSIC responsible for the custodial banking arrangement.
- Since the new law took effect, RSIC signed a new custody agreement with Bank of New York Mellon (BNYM) in July 2017.
  - RSIC staff report that since the new contract and direct relationship with BNYM has been in place the ability to acquire the desired services and the responsiveness of the custodial bank has significantly improved.
  - There is currently an effort underway to rationalize the custodial bank and investment administrator services. The concerns identified in 2014 appear to have been resolved and for this the General Assembly is again to be commended.

# 2018 Recommendations

- FAS proposes 52 detailed recommendations to build on progress and take RSIC to the next level of performance
- These are summarized by responsibility and authority on the following pages.

# General Assembly

- Delegate authority to the Commission for budgets, staffing and compensation.
- Provide an exemption to the State procurement policy for direct investment support services.
- Consider fully delegating the responsibility for setting the assumed rate of return to PEBA and RSIC.

## Commissioner Appointers

- When Commissioner terms expire, close attention should be given to the timely appointment of successor Commissioners.

# Investment Commission

- Develop a long-term (e.g., 3-5 years) strategic policy agenda to provide a framework for bringing key issues to the Commission and for planning Commissioner education in advance of addressing those issues.
- Conduct the full asset liability and asset allocation study every three to five years, including a review of the Commission's investment beliefs, with an annual review to check adherence and underlying assumptions.
- Improve on-boarding and ongoing education of Commissioners through individualized training plans and creation of a one- to two-year onboarding program.
- The Commission should work more closely with its consultant to articulate overall expectations and to leverage the consultant's capabilities for Commissioner training.

## Investment Commission (cont'd)

- Develop a succession planning process for the CEO and the head of ERM/Internal Audit/Compliance.
- Improve the Commission self-assessment process to increase Commissioner engagement.
- Update the securities litigation and ethics policies.
- With staff support, complete a three- to five-year business plan which includes assessment of internal vs. external resource requirements.

# RSIC Staff

- Expedite development of an Enterprise Risk Management (ERM) program.
- Expand the broker/dealer selection and monitoring policy, including ethics reviews and compliance attestations.
- Update the template Investment Management Agreement (IMA) to incorporate the specific requirements of the Statement of Investment Objectives and Policies (SIOP).
- Update the succession plan and staff development plans for key leadership positions.
- Continue with selection of a new investment risk management system and integrate it with investment reporting processes and the quantitative solutions group.

## RSIC Staff (cont'd)

- Continue to make refinements in due diligence and monitoring processes.
- As staff continues to develop and expand the co-investment program, develop a formal plan which considers what type of outside expertise and support is needed.
- Improve certain aspects of side letter term prioritization and related side letter processes.
- Refresh the outside counsel pool with a new RFP process (already underway).
- Pursue a service level agreement with the custodian.
- Develop a more formal IT plan which includes technology, vendor, data and disaster recovery strategies and considers overall resource requirements.

## Closing Summary

- RSIC has made impressive progress, is stabilized and professional with effective leadership, and continues to improve.
- Due to the actions of the General Assembly, the governance framework of RSIC is much improved.
- While there are still numerous opportunities for improvement in this report, our 2018 recommendations are, in many cases, opportunities to achieve leading practice.
- We hope that this 2018 report will be a helpful roadmap for the continued improvement of RSIC.