

Report Date: April 21, 2014

South Carolina Retirement System Investment Commission

***Annual Investment Plan (AIP) & Statement of
Investment Objectives and Policies (SIOP)***
for period ending December 31, 2013

To: Hershel Harper, Chief Investment Officer

We recently completed an audit of the internal controls and procedures related to the preparation and compliance of the Retirement System Investment Commission's ("RSIC") Annual Investment Plan (AIP) and Statement of Investment Objectives and Policies (SIOP) for the period July 1, 2013 - December 31, 2013. The Commission is charged with adopting an Annual Investment Plan that is compliant with Title 9 of the South Carolina statutes within certain prescribed timeframes. The SIOP is a supporting document that is also subject to compliance with South Carolina statute.

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

Based on the work performed, we concluded that internal controls as they relate to the preparation of the Annual Investment Plan (AIP) and Statement of Investment Objectives and Policies (SIOP) are adequate and operating effectively as designed, in addition to being compliant with certain South Carolina statutes for the audit period. However, we noted that improvements to the design of the internal control structure were necessary to achieve optimum risk mitigation. The nature and extent of the improvements observed are summarized as well as detailed in the Executive Summary: Overall Process Evaluation and the Action Matrix: Issues and Observations sections of this report, respectively.

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

Sincerely,

Internal Audit & Compliance

CC: Greg Ryberg, Chief Operating Officer
Allen Gillespie, Audit Committee Chair
Reynolds Williams, Investment Commission Chair

Background

Background

The Chief Investment Officer (CIO) is required, by statute, to develop and present the Annual Investment Plan (AIP) to the Commission for approval prior to April first of each year. Subsequently the Commission is required to adopt the AIP for next fiscal year no later than May first of each year. The AIP provides a yearly blueprint for investing the South Carolina Retirement System's (SCRS) plan assets and, along with the Statement of Investment Objectives and Policies (SIOP), operates as an investment framework that guides RSIC management. The statute requires the Commission to review the SIOP at least annually and change or reaffirm it. In the time period prior to the current year, the purpose and content of the AIP and SIOP were intermingled. However, RSIC determined that it was necessary to more strictly adhere to the true purpose of each document and implemented revisions during this fiscal year to appropriately segregate the documents.

It was determined that the "AIP" would be the overall general framework for investing and managing the assets of the retirement systems while achieving the Commission's investment objectives and goals. Comparatively, the "SIOP" provides the framework pursuant to which the CIO and staff prepare a draft "AIP" for submission and approval. Note that the "SIOP" document provides an opportunity to be specific about the guidelines set forth by the Commission. Both the "AIP" and the "SIOP" need to incorporate the specifics outlined by the Commission and the statute.

The current AIP was adopted on April 23, 2013 and became effective on July 1, 2013. However, the current SIOP was amended and adopted on September 26, 2013. Consequently, due to the timing of the adoption of both documents, Internal Audit determined that the scope period would cover July 1, 2013 to December 31, 2013. This means that we only examined evidence from two quarters during the current fiscal year in order to conclude on whether the AIP and SIOP are aligned with the South Carolina statutory requirements and were compliant with said requirements during the audit period.

Objectives and Scope

Objectives:

- Determine whether the current Annual Investment Plan (AIP) and Statement of Investment Objectives and Policies (SIOP) comply with the statutory requirements as outlined in Title 9 of the South Carolina Code of Laws.
- Determine whether adequate controls exist to ensure compliance with the SC statutory requirements and if such controls are effective.
- Determine through testing, whether the RSIC Investment team has been compliant with the SC statutory requirements during the first half of the fiscal year (July 1, 2013 – December 31, 2013).

Scope:

To provide executive management with an opinion on whether the newly adopted AIP and SIOP comply with South Carolina statute as outlined in Title 9 during the period of July 1, 2013 - December 31, 2013 and the adequacy of the controls over the process. The review will include the following:

- The amount invested in each asset class and whether it exceeds the parameters shown in the approved AIP and SIOP.
- Whether controls exist in each of the functions being audited and the adequacy of those controls.
- A comparison of the approved and adopted AIP and SIOP to the SC statute.
- A determination through testing as to whether the RSIC Investment team has been compliant with the portions of South Carolina's statutory requirements as it specifically relates to the AIP and SIOP for the audit period.

Scope Exclusions:

Areas outside of the scope of this audit include:

- Validation of the Compliance or Investment Performance Review Report prepared by the Consultant, HEK. Internal Audit performed no additional review or testing of the assessment performed by HEK.
- Any items related to the AIP and SIOP that are outside of the audit period for FY 2013-2014 but subsequent to its approval and adoption by the Commission.
- Internal Audit will not express an opinion on the quality of the investments purchased. We intend to only test the process around the due diligence performed prior to potential investments being presented to the Commission for approval.

Approach and Methods

Summary of Audit Procedures Performed

Procedures performed included but were not limited to:

- Reviewed current versions of AIP and SIOP (adopted on July 1, 2013 and September 26, 2013 respectively). Compared the current AIP and SIOP to the SC statutes to ensure compliance.
- Reviewed and created supporting documentation related to both Plans:
 - Created an overview of the AIP and SIOP preparation process.
 - Reviewed the consultants Hewitt EnnisKnupp (HEK) FY 2013 Compliance Report (dated September 12, 2013) and Investment Performance Review Report (dated September 16, 2013).
 - Reviewed the Investment Commission meeting minutes/presentations where the draft versions of the AIP and SIOP were discussed and adopted which includes the following meetings: April 23, 2013 and May 23, 2013
- Interviewed key personnel including CIO and other members of the Investment and Legal teams.
- Verified that a draft of the AIP and SIOP were submitted to the Commission timely (by April 1, 2013) and that approval of the AIP by the Commission was granted by May1, 2013.
- Confirmed that Commission members were provided reports at least quarterly, from which they could gauge performance.
- Established that due diligence was performed on new investments prior to them being presented to the Commission for approval.
- Verified that the Commission met at least quarterly and had an opportunity to discuss RSIC's plan performance.

Control Structure

Summary of Control Strengths:

- The Commission reviews and approves the AIP by May 1, 2013 in accordance with the statute prior to the start of the new fiscal year.
- The CIO delivers the proposed AIP by April 1st deadline in accordance with the statute.
- Commission meetings are held at least every quarter during which portfolio performance is discussed based on presentations from the CIO and the external consultant, HEK.
- Potential new investments are vetted by the Internal Investment Committee (IIC) prior to being presented to the Commission for their approval.
- Due diligence is performed on all potential new investments by the internal investment team and external consultant, HEK.
- The desired rate of return is set by statute and serves as a benchmark for performance used by the Commission.
- The Consultant reviews the portfolio for compliance with the AIP in effect during the performance period as an additional risk management measure.

Summary of Control Opportunities:

- A procedure which outlines the preparation process for the AIP was not documented with sufficient clarity to aid the CIO in developing an AIP that clearly meets the parameters outlined in the statute.
- The Commission manages and monitors the 70% allocation to equities on a cost basis which may not accurately reflect RSIC's equity position in the current market.
- The CIO currently grants conditional approval for new investments and resolutions of such conditions are not formally documented or monitored.

Summary of Process Enhancements:

- The Investment team should work with the Commission to determine which additional reports they would like to receive and incorporate those reports into the standard reporting package that is provided to them periodically. In addition to the current practice of providing performance reports on a quarterly basis, the Investment team should include some monthly performance reporting to the Commission, if desired. Due to the volatile nature of the market, timelier reporting could aid the Commission in being more responsive to changes in the marketplace.

Framework for Rating Risk of Audit Observations

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

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

High

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

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

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

Medium

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

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

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

Low

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

- Key controls and processes may be non-existent, however, significant compensating controls exist and the risk of potential weaknesses in the overall system of internal control is insignificant.
- Although sufficient compensating controls exist where weaknesses are noted, enhancements to existing processes or systems would improve effectiveness and/or efficiency.

- The financial impact of a control weakness, or potential for financial impact, appears to be limited in its amount and extent; or non-existent.

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

Other – Best Practice and or Process Improvement Opportunities

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

Risk Acceptance

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

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

Executive Summary: Overall Process Evaluation

As part of our FY2013-2014 Audit Plan, we evaluated whether the AIP and SIOP comply with the statutory requirements as outlined in Title 9 of the South Carolina statutes and whether adequate and effective controls exist to ensure compliance with the statutes.

Based on the work performed, we concluded that the AIP and SIOP for FY 2013-2014 were compliant with Title 9, Chapter 16 of the South Carolina statutes and that the controls in place were adequate and effective in ensuring that the CIO and his team , as well as the Commission comply with the statutes.

	<u>Observations</u>	<u>Risk Rating</u>
1.	There is currently no document that outlines the procedures for preparing the annual AIP and SIOP which could serve as a blueprint for proper preparation in future years.	Medium (M)
2.	The CIO provides conditional approvals for new investments and resolutions of the conditions do not appear to be appropriately documented and monitored	Medium (M)
3.	The Commission manages the statutory requirement of 70% allocation to equities on a cost basis instead of on a market basis.	Medium (M)
	<u>Process Enhancements</u>	
1.	IA noted that although quarterly investment reports are provided in accordance with the statutory guidelines, additional monthly reporting could be included as a part of the standard periodic reporting package distributed to the Commission. This additional and improved reporting would enhance the Commission’s oversight ability and aid in proactive investment management.	Other (O)

Action Matrix: Issues and Observations

Observation #1 [Medium]

Internal Audit observed that there is currently no document that outlines the procedures for preparing the annual AIP and SIOP which could serve as a blueprint for proper preparation in future years.

Risk/ Business Impact

The AIP and SIOP may not be prepared in a consistent and efficient manner. Also, the AIP and SIOP may be prepared in a manner that does not meet all the statutory requirements

Recommendation

The CIO and his team should document the process for preparing the AIP and SIOP in order to provide for continuity of knowledge and succession planning. The AIP is an important strategic document for the RSIC and this document will aid everyone involved in creating a document that meets the Commission's objectives and complies with the South Carolina statutes.

Management Actions

The Commission awaits the final recommendations from the Fiduciary Audit being performed by Funston. The CIO anticipates changes from these recommendations that may impact this process. RSIC will prioritize all recommendations set forth by the Commission.

Owner: Hershel Harper, CIO

Target Date: TBD

Individual/(s) Responsible: TBD

Target Date for Completion of Corrective Actions: June 21, 2014

Risk Acceptance: None

Action Matrix: Issues and Observations

Observation #2 [Medium]

The CIO provides conditional approvals for new investments and resolutions of the conditions do not appear to be appropriately documented and monitored. During testing, IA noted an instance in which the CIO recommended an investment for presentation to the Commission with the caveat that certain additional fee structure analysis be performed. The performance of the analysis, and hence the resolution of the concern, was not noted in subsequent Internal Investment Committee (IIC) minutes. Upon further inquiry, the Investment team was able to provide evidence showing that the additional work was performed and the results were satisfactory to the CIO. IA recommends that the CIO withhold his approval until any concerns or questions regarding a potential investment are addressed and approval can be documented in the minutes as final without conditions.

Risk/ Business Impact

New investments that do not yet fully meet investment guidelines may be prematurely presented to the Commission for approval. Presentation of an investment to the Commission usually signifies that the investment has been fully vetted internally and that fact may influence the members' vote.

Recommendation

Internal Audit recommends that the CIO withhold his recommendation if he has any reservations or additional questions regarding the potential investment. However if the CIO grants conditional approval for new investments, resolutions of conditions should be formally documented in the IIC minutes. Additionally the minutes from the IIC meeting and the final Due Diligence report should indicate that they are the final versions for proper recordkeeping.

Management Actions

The CIO may continue to grant conditional approvals, which are rare. The CIO has requested that the IIC minutes include an actions taken section to summarize all actions for that meeting. The CIO and COO, in conjunction with Legal and other staff members, review and discuss the agenda, including investments to be presented to the Commission. This is the mechanism that prevents investments prematurely going to the Commission.

Owner: Hershel Harper, CIO

Target Date: Completed

Individual/(s) Responsible: James Wingo

Target Date for Completion of Corrective Actions June 21, 2014

Risk Acceptance: None

Action Matrix: Issues and Observations

Observation #3 [Medium]

The Commission manages the statutory requirement of 70% allocation to equities on a cost basis instead of on a market basis. IA noted that the statute indicates that the maximum amount that may be allocated to equity investments on an ongoing basis should not exceed 70%. However, the statute is silent as to whether such amount should be calculated based on cost or market. Historically the Commission has used the cost basis as stated in the SIOP. However, the Investment Team should consider recommending that the Commission manage and track the equity allocation for purposes of testing compliance against the statute maximums on a market rather than cost basis. Utilizing this approach provides a more accurate reflection of RSIC's equity position as of a specific date and the difference between cost and market may be significant. Variances in the values may not be sufficient to warrant rebalancing but the Commission should be notified of what the variances are on a monthly basis.

Risk/ Business Impact

Inability to timely respond to market fluctuations due to stale dated information which could result in RSIC not being in compliance with the spirit of the guidance provided by the South Carolina legislature. Although it is unlikely that the market would shift enough to move our equity position out of the 70% range, the investment team should provide both cost and market data to the Commission.

Recommendation:

Internal Audit recommends that the Commission monitor the retirement system's equity position on a market value basis rather than on a cost basis as stated in the SIOP with monthly equity performance reports on a cost and market basis being provided by the Investment team.

Management Actions

The 70% limit was not defined in statute as to whether at cost or market. The SIOP established this limit to be determined at cost. The Investment team provides the Commission with quarterly performance reports, which include asset allocation on a market basis. The IIC monitors the asset allocation frequently to ensure compliance with the limits established within the SIOP, which includes the 70% limit to equities.

Owner: Hershel Harper, CIO

Target Date: Not Applicable

Individual/(s) Responsible: Not Applicable

Target Date for Completion of Corrective Action: June 21, 2014

Risk Acceptance: Yes

Action Matrix: Process Enhancements

Process Enhancement #1 (Other):

IA noted that although quarterly investment reports are provided in accordance with the statutory guidelines, additional monthly reporting could be included as a part of the standard periodic reporting package distributed to the Commission. This additional and improved reporting would enhance the Commission's oversight ability and aid in proactive investment management.

Risk/ Business Impact

The Commission ability to provide appropriate oversight and proactive guidance on investment issues or concerns may be impeded.

Recommendation

Internal Audit recommends the Investment team work with the Commission to determine which additional reports they would like to receive and incorporate those reports into the standard reporting package that is provided to them periodically. In addition to the current practice of providing performance reports on a quarterly basis, the Investment team should include some monthly performance reporting to the Commission, if desired. Due to the volatile nature of the market, timelier reporting could aid the Commission in being more responsive to changes in the marketplace.

Management Actions

The Commission has delegated the rebalancing authority to the CIO in order to make more frequent changes to the portfolio, within the parameters established within the SIOP. If warranted by extreme volatility within the markets, the Commission can call a special meeting to review and discuss changes to the investment strategy. Reporting overall is expected to be part of the Commission's strategic planning discussions in June 2014. Therefore, the CIO has inserted "TBD" (to be determined) for the target date and who will be responsible.

Owner: Hershel Harper, CIO

Target Date: TBD

Individual/(s) Responsible: TBD

Target Date for Completion of Recommendation August 1, 2014

Risk Acceptance: None