

South Carolina Retirement System

Investment Commission

Investment Fees and Expenses Audit

For FYE June 30, 2013 and June 30, 2014

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


We recently completed a review of the accuracy and completeness of the Retirement System Investment Commission's ("RSIC") investment related fee and expenses ("IFE") disclosed for the fiscal year ending June 30, 2013 and June 30, 2014. We also reviewed the internal controls and procedures related to the IFE that existed during the period of July 1, 2013 – June 30, 2014. While the South Carolina Code of Laws does not require that RSIC disclose detail of investment fees and expenses paid, RSIC has opted to disclose such fees and expenses at a level that exceeds industry and regulatory standards. Detail of investment fees and expenses paid are disclosed in the Annual Investment Report and in the Retirement Systems' financial statements. To help ensure compliance with the statutory requirement prescribed in 9-16-90 and ensure accuracy of information disclosed, it is incumbent upon RSIC staff to establish and monitor the effectiveness of internal controls around the collection and disclosure of investment fees and expenses.

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

Based on the work performed, we concluded that overall the investment fees and expenses for Fiscal Years 2013 and 2014 were materially accurate and complete, and complied with statutory requirements. We observed that management has implemented a number of recommendations from the prior review, however the internal control structure is evolving and further improvements are needed. These improvements should enhance management's assurance of sustainable compliance year over year regardless of staff personnel changes. We have summarized and detailed the nature and extent of our observations in the "Executive Summary: Overall Process Evaluation" and in the "Action Matrix: Issues and Observations" sections of this report, respectively.

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

Sincerely,



Monica Houston, CPA
Chief Audit Officer

CC: Allen Gillespie, Audit Committee Chair
Ed Giobbe, Investment Commission Chair

Michael Hitchcock, Executive Director

Background

Background

As mandated by South Carolina statute 9-16-90, a schedule of the sum total of investment expense is a required disclosure by RSIC annually in the Annual Investment Report (“AIR”) provided to the SC Legislature. Additionally, investment fees and expenses (“IFE”) is disclosed publicly in conjunction with the Public Employees Benefit Authority’s (“PEBA”) release of the South Carolina Retirement Systems’ (“SCRS”) financial statements as a part of the annual Comprehensive Audited Financial Report (“CAFR”).

Investment fees are incurred, charged, and as appropriate paid by the SCRS Pension Trust Funds on a monthly basis. The investment fees are separated into two categories, invoiced and non-invoiced. Invoiced fees are those fees and investment-related costs for which the fund manager provides an invoice and for which payment must be sent to the fund manager by PEBA on behalf of SCRS. Non-invoiced fees are those fees and investment-related costs which are netted against the gain/loss of the investment and reflected directly in the Net Asset Value (NAV) of the investment; no cash is involved. As stated previously, S.C. Code §9-16-90(b)(3) requires RSIC to provide a schedule of the sum of total investment expense for the fiscal year in an annual report. In an effort to comply with this legislative requirement to a greater degree and to provide greater transparency, in 2009 RSIC embarked upon the challenging process of disaggregating the fee amounts that were not readily separable from specific investment income, i.e. non-invoiced fees. The identification and collection of the investment expenses that as a standard are netted out of income has proved to be an extremely complex and challenging process and as a result the process has been continuously evolving over the years. In 2013, the RSIC Investment Reporting team modified the timing of its approach for collecting investment fee data from the fund managers from an annual basis to a quarterly basis; aggregation of the data still occurs on an annual basis. While there can be a lag in the timing of the data collected from investment managers, the reporting team is able to include four quarters of data in the aggregated balance for each specific investment fund.

During fiscal year 2014, RSIC management sought to outsource the process for collection and aggregation of IFE as part of an overall investment administrator solution. Bids were solicited for an investment administrator to develop and implement a turn-key technology solution as well as provide associated administrative services. RSIC expected the solution to include data migration, testing, provision of training to RSIC and PEBA employees and documentation of training (user manuals and procedures). On March 20, 2014, the contract for the investment administrator was awarded to Conifer Financial Services, LLC for a period of seven years (7) in the aggregate amount of \$8.2 million. The transition of the responsibility, from the RSIC fee team to Conifer, for collecting and validating IFE began in July 2014 and is now in its final stages. After the transition, RSIC will be responsible for the periodic review and monitoring of the services provided by Conifer which is anticipated to provide more efficient use of the personnel resources.

The IFE amounts reported for Fiscal Year ended June 30, 2014 were disclosed in the CAFR published in December 2014 and is scheduled to be published in the AIR expected to be released in February 2015.

Objectives and Scope

Objectives

The objectives of this audit were to:

- Determine through testing whether the current management fees and expenses as published complies with the minimum statutory requirements of the South Carolina Code of Laws per 9-16-90 (b) (3).
- Determine whether adequate controls exist to ensure accuracy and completeness of the published management fee expense and if such controls are effective.
- Determine whether the process for gathering management fees and expenses data has been consistently applied during the period.
- Determine whether the published management fee expense is accurate and complete.
- Determine whether the agreed upon recommendations from the previous year's review have been implemented and operational during the period.

Scope

The FY 2014-15 Risk Assessment performed by RSIC Internal Audit determined the risk level of the Investment Fees and Expenses process to be "High". Thus, an audit of Investment Fees and Expenses ("IFE") is being conducted in accordance with the approved FY 2014-15 Audit Plan. The scope of the audit is to identify the key controls that mitigate the risk inherent in the process of providing an accurate and complete balance of investment fees and expenses for the period ended June 30, 2014 as well as determine the adequacy and effectiveness of those controls. Additionally, the accuracy and completeness of the investment fees and expenditures disclosed for Fiscal Year ended June 30, 2013 and June 30, 2014 will be determined. Based on the implementation and use of a quarterly process, Internal Audit determined that the period under audit should be July 1st, 2013 – June 30, 2014.

Approach and Methods

Summary of Audit Procedures Performed

Procedures performed included but were not limited to:

- Obtaining an understanding of the management fees and expenses process
- Identifying the controls which exist in each of the critical stages of collecting, validating, and aggregating the data as well as documenting any gaps
- Through inquiry, observation, review and re-performance determining the adequacy of the identified controls.
 - o A comparison of the process for first time validations vs. subsequent validations.
 - o Reviewing the executed contract and amendments, confirming agreement of the expense and fee terms to the validation template, and re-performing the calculations for a selected sample of funds
 - o Determining through inquiry and review that the review procedures over the final aggregated management fees and expenses performed by the fee and investment teams are adequate and effective.
- Reviewing the South Carolina statutory requirements for reporting of management fees and expenses and determining the level of compliance.
- Confirming agreement of balances reported in the Comprehensive Audited Financial Report (“CAFR”) and in the Annual Investment Report (“AIR”) as well as validating such to source documentation.
- A comparison of funds included in the aggregation to a fund listing obtained from the custodian.
- Review prior audit findings and recommendations and determine status of management action.

Control Structure

Summary of Control Strengths

- The total management and performance fee amounts are vetted and validated by the fee team on a quarterly basis after reviewing support from the fund managers.
- After a long process of identifying qualified parties, RSIC hired an administrator, Conifer, to handle the quarterly validation of the fees on a going forward basis effective July 1, 2014. The hiring of the administrator is intended to provide detailed reports as well as increase the fee team's ability to provide more in depth analysis to management. The transition appears to be progressing.
- The RSIC fee team has been gaining experience, honing its methodology and continuously upgrading current procedures in its efforts to make the fee data collection process more efficient.
- In addition to the fee team, the aggregated fee amounts are also reviewed for reasonableness by the Investment team based on their knowledge and relationship with the asset managers.
- The fee team has implemented some of Audit's previous recommendations which have strengthened the control environment.

Summary of Control Opportunities

- Reviews are not appropriately evidenced and the process for performing such is not adequately included in the process documentation.
- Changes in contract terms or fees are not tracked and communicated in a consistent manner
- Spreadsheet controls are not utilized to protect templates used in the validation process from errors or irregularities.
- Changes or adjustments to the validation templates are not adequately and consistently supported or documented.
- Management direction and/or decision rationale relative to the accounting treatment of errors that affect prior periods is not formally documented or supported.

Framework for Rating Risk of Audit Observations

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

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

High

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

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

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

Medium

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

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

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

Low

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

- Key controls and processes may be non-existent, however, significant compensating controls exist and the risk of potential weaknesses in the overall system of internal control is insignificant.
- Although sufficient compensating controls exist where weaknesses are noted, enhancements to existing processes or systems would improve effectiveness and/or efficiency.
- The financial impact of a control weakness, or potential for financial impact, appears to be limited in its amount and extent; or non-existent.

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

Other – Best Practice and or Process Improvement Opportunities

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

Risk Acceptance

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

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

Executive Summary: Overall Process Evaluation

As part of our FY 2014-15 Audit Plan, we evaluated the accuracy and completeness of the Retirement System Investment Commission's ("RSIC") investment related fee and expenses ("IFE") disclosed for the fiscal year ending June 30, 2013 and June 30, 2014. We further determined whether the disclosed IFE complied with statutory requirements. Additionally, we assessed the adequacy and effectiveness of the internal controls and procedures related to the IFE that existed during the period of July 1, 2013 – June 30, 2014.

Based on the work performed, we concluded that overall the investment fees and expenses for Fiscal Years 2013 and 2014 were materially accurate and complete, and complied with statutory requirements. However, we noted the following observations during the audit:

	<u>Observation</u>	<u>Risk Rating</u>
1.	Management's annual review of the quarterly fee validations is not appropriately documented and the "Fee Validation and Aggregation" process documentation needs to be more detailed.	Medium (M)
2.	During IA's testing of the validation process, we noted that there was no consistent and/or documented procedure for the tracking of changes in contract terms or fees.	Low (L)
3.	During testing, auditor noted that there are no spreadsheet controls in place over the actual spreadsheets used to validate management fees.	High (H)
4.	In one of the twenty five sample items tested, IA found that changes or adjustments to fees may not adequately supported prior to the changes being made on the validation template.	Low (L)
5.	Internal Audit noted that no formal policy existed to guide management in the treatment of retroactively identified errors. Further, the rationale of the decision was not documented for future accounting guidance.	Medium (M)

Action Matrix: Issues and Observations

Observation #1 [Medium]

Management performs an annual review of the quarterly fee validations, however it is not appropriately documented. Additionally, detailed procedures relative to the annual management review process are not included in the Fee Validation and Aggregation process documentation.

Risk/ Business Impact

The lack of segregation of duties and proper review procedures are critical factors in the overall internal control structure and are effective in the mitigation of certain risks. Errors, irregularities, or noncompliance of a material nature could result in the material misstatement of management fees, damage to RSIC's public image, and negative impact on agency funding. Additionally, not documenting the review process performed by someone at a higher level, could result in a loss of the ability to transfer knowledge and disrupt the continuity of this function if other employees are not properly trained. Failure to document the review process could result in inefficiency and ineffective use of agency resources.

Recommendation:

1. Evidence of the annual review of the fee aggregation process by both the fee team and investment team should be documented and maintained.
2. The quarterly and annual review processes should be outlined in detail within the management fee policies and procedures including the manner in which the quarterly and annual reviews will be documented.

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

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

Recommended Target Date : April 2015

Risk Acceptance: No

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

Target Date for Completion of Corrective Action: April 30, 2015

Action Matrix: Issues and Observations

Observation #2 [Low]

During IA's testing of the validation process we noted that there was no consistent and/or documented procedure for the tracking of changes in contract terms or fees. Contract terms are a critical element in the recalculation of management and particularly performance fees. At this time, the fee team may become aware of changes to contract terms which impact the fee structure when they validate the fees quarterly or are notified by another group (Investment team or Legal).

Risk/ Business Impact:

The validation process could become more efficient through the consolidated documentation and tracking of changes to existing contract terms. Not implementing a process for tracking contract changes can cause increases in unproductive time and inefficiency due to additional time being spent on trying to find the reasons for variances in the anticipated and actual fees during the validation process.

Recommendation:

Development of an ongoing procedure or process that would appropriately validate and document any upcoming changes to existing terms and conditions to the management fee contracts.

1. The fee team should consider creating a separate repository for maintaining upcoming changes to key contract terms and conditions.
2. The fee team should work with the Investment and Legal teams to devise a plan to disseminate pertinent change information more timely.

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

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

Recommended Target Date: June 2015

Risk Acceptance: No

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

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

Action Matrix: Issues and Observations

Observation #3 [High]

During testing, auditor noted that there were no spreadsheet controls in place over the actual spreadsheets used to validate management fees. Note also that the process for creating a new quarterly template utilizes a macro which should be checked for errors annually.

Risk/ Business Impact

Failure to accurately transfer data from one quarter to the next can result in errors of a material nature, which if not corrected could result in the understatement or overstatement of management fees and expenses. Failure to implement and use spreadsheet controls can compromise the accuracy and integrity of the data and the proper authorization of procedures performed.

Recommendation:

1. The fee team should establish a process to monitor and train the Conifer users to ensure the transference of the quarterly data with minimal errors.
2. The fee team should implement appropriate spreadsheet controls over the validation templates including the quarterly checking of the validation template's macro.

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

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

Recommended Target Date: March, 2015

Risk Acceptance: No

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

Target Date for Completion of Corrective Actions March 31, 2015

Action Matrix: Issues and Observations

Observation #4 [Low]

In one of the twenty five sample items tested, IA found that changes or adjustments to the fee validation template inputs may not adequately supported prior to adjusting the validation model. When there variances, the fee team often follows up with the manager and the manager's answer can cause an adjustment without much documented support. Since the data supporting the change is sometimes verbal, there is not always documented evidence to support the change or adjustment.

Risk/ Business Impact

Failure to maintain support for material adjustments to the validation template and the financial statement for a reasonable period of time can result in RSIC's inability to recreate the change and provide evidence of the adjustment to a number on the validation template and published in the financial statements.

Recommendation:

Audit recommends that the fee team obtain and maintain support as well as document the reason for the change on the validation template prior to adjusting the fee validation model.

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

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

Recommended Target Date: June 2015

Risk Acceptance: No

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

Target Date for Completion of Corrective Actions: June 2015

Action Matrix: Issues and Observation

Observation #5 [Medium]

IA noted that as a result of the validation procedures being properly performed, an error was identified which required management to make a decision on the financial reporting for such. It was further noted that no formal policy existed to guide management in the decision and that after the decision was made, the rationale and future application of such decision were not documented as a matter of policy and or procedure.

Risk/ Business Impact

Lack of accounting policies and procedures could result in the inconsistent treatment and recording of financial information which could impact RSIC's reputation and loss of trust from stakeholders. There should be an established policy in place that determines what the criteria and threshold should be for reporting adjustments to PEBA. Adjustments to numbers on the financial statements should be adequately supported and the evidence supporting the adjustment should be maintained and accessible for a reasonable period of time.

Recommendation

Internal Audit recommends that Management develop and document a policy that they will use to aid them in determining which adjustments warrant booking.

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

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

Recommended Target Date: April 2015

Risk Acceptance: No

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

Target Date for Completion of Corrective Actions: April 2015