

**South Carolina Retirement System Investment Commission
Audit Committee Meeting Minutes**

September 8, 2011

**15th Floor Conference Room
1201 Main Street
Columbia, SC 29201**

Committee Members Present:

Mr. Allen Gillespie
Mr. Reynolds Williams
Dr. Travis Pritchett

Others present for all or a portion of the meeting on Thursday, September 8, 2011:

Bob Borden, Sarah Corbett, Nancy Shealy, Robert Feinstein, Adam Jordan, Lorrie King, Lorelei McKay and Dori Ditty from the South Carolina Retirement System Investment Commission; Adam Beam from *The State*; Roger Smith and Joanie Lawson from the South Carolina Education Association; Michael Chung from Deloitte and Touche; Kent Lesesne from South Carolina Association of Counties.

I. Call to Order – Mr. Gillespie called the meeting to order.

II. Election of a Chairman of the Committee – Mr. Gillespie announced that a Chairman for the Committee needed to be elected, and opened the floor for nominations. By unanimous consent of the members of the Committee, Dr. Pritchett served as Acting Chairman for purposes of acting on the nominations. Dr. Pritchett nominated Mr. Gillespie, Mr. Gillespie seconded the motion, and it was approved unanimously. Mr. Gillespie thereupon assumed responsibilities as Chairman of the Committee.

III. Discussion of the Audit Committee Charter – Mr. Borden introduced Mrs. Corbett, the Deputy Chief of Staff for the Retirement System Investment Commission (RSIC or Commission), to the Committee and asked her to provide an overview of the Deloitte engagement. Mrs. Corbett explained that Deloitte and Touche (Deloitte) was engaged to assist in the implementation of the Commission's Internal Audit function and to perform a Risk Assessment. Development of the Internal Audit function focused on three things: developing a charter for the Audit Committee, creating a job description for and recruiting a Director of Internal Audit and writing first year risk-based audit plans. Mrs. Corbett introduced Mr. Michael Chung, the project lead from Deloitte.

Mrs. Corbett reviewed the Charter for the Audit Committee. She stated that the charter was based in part on the Association of Public Pension Fund Auditors (APPFA) sample charter and noted that Deloitte actively assisted in developing the charter. Dr. Pritchett asked for clarification about the reporting lines for the Director of Internal Audit, noting that while the Director will report to the Committee, there was a provision in the charter for administrative functions to be approved directly by the CEO/CIO or one of his delegates. Dr. Pritchett asked for an explanation of what those administrative items

would be. Mr. Borden replied that he would be directly involved in addressing matters such as leave, travel and procurement, but noted that evaluation, direction and selection of the Internal Audit Director will be done by the Committee. Mr. Borden added that the Commission may need to amend its governance policies, including the policy regarding responsibilities of the CEO/CIO, to make sure the policies reflect that the Audit Committee has the authority to hire and fire the Internal Audit Director.

Mr. Gillespie clarified that the Committee charter would need to be approved by both the Committee and the full Commission because of the powers that are to be delegated to the Committee. Mr. Williams asked what specific powers are to be delegated to the Committee. Mrs. Corbett noted that the charter gives the Committee power to hire and fire a Director of Internal Audit, as well as the power to oversee the Director of Internal Audit. Mrs. Corbett noted that at such time in the future as the Commission becomes responsible for producing its own financial statements and has its own external auditor, the Audit Committee would oversee these functions as well. Mr. Gillespie added that the procurement of services and vendors usually lies with the Commission, but for audit services as identified in the charter, it is now delegated to the Committee. Chairman Gillespie explained that he wanted to keep the Commission notified of all decisions made by the Committee and noted that such reporting requirements had been included in the charter.

Mr. Borden asked Mrs. Corbett if the Committee will oversee an audit plan once it is developed by the Director of Internal Audit. Mrs. Corbett affirmed that the Committee will oversee the audit plan, noting that this item is included in the list of primary responsibilities for the Committee set forth in the charter. The mechanism for reporting, and frequency with which the Committee would report to the full Commission was discussed.

Mrs. Corbett added that the compliance function will initially be housed within Internal Audit and will report to the Committee. Mr. Borden explained that in a steady state with a fully developed staff, the compliance function may be housed in Risk Management or elsewhere, but since that infrastructure does not presently exist, Deloitte and staff believe that housing compliance within Internal Audit is the best interim solution. Dr. Pritchett asked if the compliance staff member will report to the Director of Internal Audit. Mr. Borden noted that there are some issues with this arrangement, as the audit function tends to be an ex-post function, while compliance is a real-time function. Mrs. Corbett confirmed that the compliance function will report to the Internal Audit Director and that she does expect some cross training between the audit and compliance functions.

Mr. Williams made a motion to approve the Audit Committee Charter as presented. Dr. Pritchett seconded the motion, and it was approved unanimously. The Charter will be submitted to the full Commission for approval.

(Information relating to the matter has been retained in the Commission's files and is identified as Exhibit A.)

Mr. Borden noted that revisions to the existing governance policies needed to accommodate the Audit Committee charter will be added to the agenda for the next Commission meeting.

IV. Discussion of the Memorandum of Understanding – Mrs. Corbett directed the Committee to the draft Memorandum of Understanding (MOU) with the South Carolina Retirement Systems (SCRS). Mrs. Corbett explained that the SCRS had produced an initial draft of the MOU. RSIC staff has made changes to the document and intends to send it back to SCRS for review. Mrs. Corbett reviewed provisions which staff proposes to add to the MOU regarding the external audit. Mrs. Corbett explained that SCRS currently prepares financial statements for the trust fund which includes investment information. Because the RSIC does not currently prepare its own financial statements, the SCRS' external auditors have to review investment information to ensure the validity of the valuation of the investments as presented on the financial statements. Staff is also seeking to include language in the MOU requiring that (i) SCRS invite the Audit Committee or its designee to participate in the entrance and exit conferences with the external auditors; (ii) SCRS ensure that the engagement letter with the external auditor contains appropriate confidentiality provisions as required by RSIC contracts; and (iii) SCRS and RSIC meet prior to and during the audit to review any significant accounting or reporting issues identified during the external audit or preparation of the financial statements.

Mr. Borden stated that a goal of the Commission is to be independent in the IT area, and noted that a Director of IT, Mr. James Manning, had recently been hired, but indicated that, in the interim, the MOU reflects that RSIC will continue to rely upon SCRS for certain IT functions. Mr. Borden went on to explain that in the long term, the RSIC may not need SCRS to produce financial statements once a reporting infrastructure is in place, but said he believes that won't happen for another three years or more. Mr. Borden added that it is very important for the Commission to have this MOU in place, so that there is clarity about the functions and responsibilities which SCRS has agreed to perform.

Mr. Gillespie asked if SCRS has looked at and approved the current draft. Mrs. Corbett said SCRS has not seen this draft yet, and added that the two main sets of changes proposed in the current draft relate to the external audit and confidentiality provisions. Mr. Borden added that staff also removed certain responsibilities and functions, such as administrative functions that RSIC now performs independently from SCRS.

In response to a question from Mr. Gillespie, there was discussion of staff training and audit compliance testing which may need to be implemented over time to cover various Commission policies (e.g., personal trading).

Mr. Williams made a motion to submit the Memorandum of Understanding to SCRS for approval. Dr. Pritchett seconded the motion, and it was unanimously approved.

(Information relating to the matter has been retained in the Commission's files and is identified as Exhibit B.)

V. Internal Audit Position Description – Mrs. Corbett opened the discussion of the job posting for a Director of Internal Audit. She explained that it was written by Deloitte and reviewed by RSIC staff. Mrs. Corbett recommended that the Commission hire a candidate who is a Certified Public Accountant, Certified Internal Auditor, or Certified Information Systems Auditor. Mrs. Corbett asked for authority to post the job, and proposed the following recruitment process for the Committee’s consideration. RSIC staff would post the opening, and collaborate with Deloitte in screening applicants and conducting initial interviews. The Committee would perform final interviews with the top two or three candidates and make a selection. Mr. Borden noted that the Commission’s contract with Deloitte contemplated that Deloitte would be very involved in the screening process.

Dr. Pritchett asked about the plan for posting the job. Mrs. Corbett responded that the job will be posted on the State’s employment website [jobs.sc.gov], and suggested posting the job in the State newspaper first to find local candidates, as well as using Monster.com and NASRA. Mr. Borden asked Mrs. Corbett if AICPA or APPFA have job postings, too. Mrs. Corbett responded affirmatively, and agreed to look into using those outlets. Dr. Pritchett said he would like a broad posting. Mr. Gillespie agreed, and noted it would be best to find candidates with in-depth experience. Mr. Chung said Deloitte has tapped its network to reach markets outside of Columbia, and knows of some potential candidates.

Mr. Williams made a motion to approve the posting of the job for a Director of Internal Audit, and the payment of any fees that accommodate said postings. Dr. Pritchett seconded the motion, and it was approved unanimously.

In response to a request for clarification, the members of the Committee confirmed their concurrence with staff’s proposed recruitment process. Mr. Gillespie suggested that as many as five candidates be presented to the Committee. Mr. Williams concurred.

VI. Review of results of the Risk Assessment – Mr. Chung began the discussion of the Risk Assessment performed by Deloitte. Mr. Chung explained that the Risk Assessment deals only with the operating functions of RSIC and its investment activities. Mr. Chung continued to explain that the Risk Assessment was segmented into seven categories: Investment Management, Legal, Compliance, Risk Management, Operations, Technology and Internal Audit. He said Deloitte looked at the people, process and technology factors associated with these seven functional areas. Deloitte then conducted an assessment of the functional areas and factors from two perspectives -- inherent risk and residual risk. A team from Deloitte met with all staff and adopted a three-tier scale of residual risk levels (high, medium and low). Mr. Chung explained that there are no low risk areas, noted the very short period of time (2006 – present) during which the Commission has been in existence, commended the improvements that have been made since the Commission’s inception, and stated that Deloitte’s assessment focused on things left to accomplish.

Mr. Chung reviewed the priority recommendations for the Commission listed in the report. The first recommendation is to establish a dedicated internal audit function and enhancing reporting capabilities. Mr. Chung noted this may involve developing new

reporting capabilities, and emphasized the important role that the technology function plays in facilitating reporting. This first recommendation impacts the Investment Management, Legal, Risk Management, Operations and Compliance areas.

The second recommendation is to improve communications throughout the Commission, both horizontally across all functional areas and vertically within the functional areas. The third recommendation is to develop a succession plan and a talent management plan. The fourth recommendation is to expand and implement standard due diligence processes across all asset classes. Mr. Chung indicated that this recommendation will impact the Investment Management and Operations areas. The fifth recommendation is to develop a formal compliance function to span across all functional areas. Mr. Chung noted that, at the moment, the Commission is housing internal audit and compliance as one entity in order to get it started, but stated that, in the longer term, Deloitte recommends that the Commission consider developing an independent compliance function. Mr. Chung explained that compliance's primary responsibility is to perform various monitoring and surveillance activities on a day to day basis, whereas the internal audit function conducts reviews after the fact.

Mr. Williams asked whether the analytical framework used in the assessment factored in the consequences of failure. Mr. Chung replied that Deloitte has included this information in its assessment. He offered as an example the investment area. In order to manage the portfolio, the investment professionals need to understand all of the portfolio's constituent parts with all its variables. The availability of complete and accurate data and information is critical to successful management of this function. In Deloitte's assessment, the Commission needs to enhance its technology infrastructure, and build out reporting capabilities, so that those in charge of managing the portfolio have accurate information needed in order to make well-informed decisions. Mr. Williams asked if the five recommendations noted above were the implicit, end result of that analysis. Mr. Chung replied affirmatively.

Mr. Chung continued to explain that there are different scenarios listed in the report with varying numbers of FTEs and corresponding timeframes for completion of these recommendations. Mr. Chung stressed, however, that the primary focus of the Deloitte report was on the short term and those areas where the Commission will get the greatest amount of benefit.

Mr. Chung explained that Deloitte also looked at RSIC's current organizational structure and assessed the RSIC's business operations to arrive at the priority recommendations detailed in the risk assessment. He noted that the Commission was recently approved for twelve additional FTEs, and reviewed recent hires that have been made, as well as the planned recruitment for the Director of Internal Audit position. Mr. Chung continued by noting that enhancing the legal team is a priority, as is having a compliance staffer, and a Director of Risk Management. Within operations, the addition of a CFO/Chief Administrative Officer as well as a reporting specialist will help to spearhead reporting initiatives. Mr. Chung noted that the Commission's external manager due diligence process should include operational due diligence (that is, the operations and technology areas) as well as investment due diligence, and recommended that someone at RSIC focus on these areas. Mr. Chung added that while the Director of Technology position

has been filled, additional staff will be needed to support this function. Based on Deloitte's assessment, Mr. Chung stated that 14 additional FTE positions are needed.

Mr. Chung continued to review Deloitte's estimated man-hours necessary to accomplish the priority recommendations as detailed in the risk assessment. In response to a question from Mr. Borden, Mr. Chung clarified that (a) it would take a little over two man-years to complete the 'up front' work to build out functions along the lines recommended by Deloitte and (b) the 14 FTEs would be needed to carry out these enhanced functions on an ongoing basis. There was discussion regarding the challenges of making the up front investment of time in a situation where existing staff is already tasked with performing other mission critical responsibilities. Mr. Gillespie commented that the man-hours which will be saved after these more efficient functions are in place will be much more significant. Mr. Chung concurred, noting that the challenge is to make an upfront investment in order to be able to operate more efficiently and effectively over time.

Mr. Chung turned to the second component of the risk assessment project -- putting together the first year audit plan. Mr. Chung stressed the importance of permitting the build out work to be concluded and a 'steady state' achieved in a functional area before routine audits of the area are commenced. Mr. Borden noted two factors that will require additional time as the RSIC undertakes implementation of the recommendations made by Deloitte. First, the recruitment, on-boarding, and training process for new employees has proven to be lengthy and difficult for RSIC. The second factor identified by Mr. Borden was the annual State budgeting process. This process ultimately determines the extent to which the Commission's considered assessment of its strategic goals and resource requirements can be implemented. Mr. Borden concluded by noting that these two factors can have a dramatic impact on the timeframe for completing these initiatives. Mr. Chung explained some of the resource and other assumptions made by Deloitte in arriving at its estimates of the time required to complete the 'up front' work to build out functions along the lines recommended by Deloitte.

Mr. Gillespie suggested outsourcing certain of the tasks. Mr. Borden concurred, and reviewed the relative merits of the 'buy vs. build' decision that RSIC faces in the reporting area. Mr. Borden noted that building this infrastructure internally is problematic for a number of reasons, including complexity of this multi-year project, recruitment of appropriate staff and ability to obtain the necessary budget approvals. Mr. Borden opined that outsourcing this project, with appropriately resourced oversight by RSIC staff, makes more sense, but noted that the outsourcing of this project will be expensive, and will require going through procurement and budgeting processes. Mr. Borden indicated that some of these expenses could be bundled into strategic partnerships, but a certain portion of the cost will likely be a direct expense, and noted that the RSIC's current fiscal year budget does not contain an allocation for such expenditures. The next steps outlined by Mr. Borden included: (i) making some provision for reporting project expenditures in the RSIC's budget request for the fiscal year commencing July 1, 2012 (FY 2012-13), (ii) seeking budget approval and (iii) commencing the procurement of resources to implement the project. Mr. Chung agreed with Mr. Borden, and recommended that the Commission make a cost-benefit analysis evaluating whether it is more cost-effective and efficient for RSIC to outsource such projects and oversee the work done by outside firms or perform work in-house.

Mr. Borden noted that there are certain findings within Deloitte's assessment that RSIC has the resources to handle internally, such as due diligence. By contrast, Mr. Borden indicated that the organization's reporting needs and human resources management are the two areas that warrant significant, immediate intervention and external assistance.

In response to a question from Mr. Williams, Mr. Borden indicated that the vast majority of the reporting and IT enhancement tasks that need to be completed could be handled through outsourcing. Mr. Chung reiterated that while Deloitte outlined five discrete areas, they are all interrelated. For example, as technology enhancements are made, there will be a positive impact on all five areas.

Mrs. Corbett stated that the main concern is the base technology infrastructure, because it affects the entire organization. Mr. Gillespie agreed, as did Mr. Chung. Mrs. Corbett discussed next steps in the implementation effort. She stated that specifications need to be developed by the RSIC, so that a search for providers can be conducted and costs determined. Mr. Borden reiterated, however, that due to the realities of the budgeting process, the Commission is required to first estimate what it will need to pay a vendor, and seek budget approval, before it can conduct this type of procurement and ascertain the actual costs.

In response to a question from staff, Mr. Chung stated that in an ideal state (that is, without taking budgeting and other constraints into consideration), RSIC would have 53 FTEs. He noted that RSIC had previously performed a similar exercise which yielded a similar figure (approximately 60 FTEs). It was noted that RSIC currently has 23 FTEs, with existing approval to hire 12 additional FTEs, for a total of 35 FTEs. Mr. Chung indicated that Deloitte believes that 14 additional FTEs are needed. He then clarified that the additional 14 FTEs are not Deloitte's suggestion as to the ideal size for the organization, but rather Deloitte's assessment of the absolute minimum staffing requirement, given the RSIC's complexity and needs. Mr. Borden added that when RSIC developed its assessment of ideal staffing levels, it also surveyed other enterprises that had a size and level of portfolio complexity similar to RSIC, and found the average number of FTEs was 53. Mr. Borden indicated that he believes 47 to 60 FTE's are necessary to address the risks identified in Deloitte's assessment and implement the strategic plan initiatives that the Commission has approved.

The Committee requested staff's guidance as to actions which need to be taken by the Committee and the full Commission with regard to the Deloitte risk assessment. Mr. Borden indicated that because the Deloitte risk assessment contains recommendations that impact the budget, these recommendations will be discussed at next week's Budget Committee meeting and the September Commission meeting. Mr. Borden reminded the members of the Committee, however, that even if the Commission determines to include funding in the proposed FY 2012-13 budget to address recommendations made in the Deloitte risk assessment, and the proposed budget gets approved by the Legislature and Governor, it will not take effect until July 2012, so RSIC needs to work within the confines of the current fiscal year budget to see what parts of the action plan can be accomplished now. Depending on the outcome of the budget approval process, Mr. Borden noted that the RSIC's action plans may have to again be revisited and

reprioritized, and determinations made as to those risks/issues that can be promptly addressed, and those which must be deferred. Mr. Gillespie agreed, noting that the Committee will also need to advise the full Commission of the impact of these decisions on the conduct of the audit function generally and approval the audit plan specifically.

Mr. Borden warned that if the necessary resources are not provided, the fiduciaries of the Commission may have no choice but to systematically simplify the portfolio in order to manage it with the current resources. Mr. Borden expressed the hope that the Deloitte report will be viewed as an independent 'proof statement' which serves to validate and support the Commission's budget requests. Mrs. Corbett said the duty of the Audit Committee is to monitor the follow up on the matters addressed in the Deloitte report, so as to ensure that risks are identified and solutions are implemented.

Mr. Williams asked if there is any prospect of getting multi-year budgeting. Mr. Borden said this concept had previously been unsuccessfully explored, but indicated that it could be revisited. Mr. Borden noted that most of the topics Deloitte highlighted in its report are already addressed in the Commission's strategic plan. Discussion ensued regarding how to incorporate Deloitte's recommendations into the Commission's strategic plan. Mr. Borden stressed the importance of identifying and prioritizing items for inclusion in the budget, and opined that technology and reporting are the most important and urgent areas of need. Mr. Chung added that he believes human resources (talent management) is tied very closely to technology and reporting, and he believes they should all be implemented concurrently. Mr. Borden concurred.

Mr. Borden suggested that consideration be given as to how to promptly structure and implement follow-on consulting arrangements for (a) building the technology and reporting infrastructure and (b) addressing human resources issues. Mr. Gillespie noted that a crucial first step would be to articulate the requested scope of services. Mrs. Corbett noted that staff has developed a draft scope for a reporting consultant, as well as a draft scope for a reporting system. A draft scope does not yet exist for an HR consultant. With regard to reporting, Mrs. Corbett suggested that an initial decision needs to be made as to whether a reporting consultant should be engaged in order to help staff refine specifications for a system, and provide assistance with the necessary procurement efforts. Mr. Borden opined that a consultant would provide services which are not currently available on staff.

Mr. Gillespie suggested that it might be helpful for the commissioners to be provided with information regarding the services which these consultants and vendors can perform. Mr. Borden agreed, and suggested that it might be helpful to also construct a supporting schematic showing the portfolio's complexity. In the interim, Mr. Borden suggested that the Commission needs to work within the current budget process and develop a proposed budget for FY 2012-13 that will support the Commission's plans. Concurrently, determinations need to be made as to what can be accommodated in the current fiscal year budget to address recommendations made in the risk assessment.

Discussion turned to process and next steps. Mr. Gillespie stated that the Committee needed to accept Deloitte's report, so that it can be presented to the full Commission.

Mr. Borden agreed, and added that, thereafter, the Committee will be asked to recruit a Director of Internal Audit and develop an appropriate audit plan, reporting regimen, etc.

It was noted that Deloitte is still working on deliverables relating to the audit program and first year audit plan. After discussion, there was consensus that the Committee should attempt to meet prior to the November Commission meeting. One item of business at the Committee's next meeting will be the consideration of candidates for the Director of Internal Audit position.

As to other potential items, Mr. Chung said Deloitte has prepared a draft of an audit program, but development of the actual first year audit plan is dependent on several factors, including work that first needs to be done to build out functions. Mr. Gillespie noted that one area of focus should be reporting regarding strategic partnerships. Mr. Williams agreed. Mr. Chung said the plan can start there, but reiterated that the objective should be to have an 'auditable' audit plan. It was agreed that staff will work with Mr. Chung to determine topics for inclusion in the audit plans.

There was further discussion of potential audit programs and steps which could be implemented with regard to the strategic partnerships. The discussion covered transfers in and out of the strategic partnerships and valuation issues. There was consensus that it would be helpful to evaluate the adequacy and reasonableness of stated valuation processes, and testing of compliance to these stated processes. In addition to this item, Mrs. Corbett reiterated that staff will work with Mr. Chung to identify other topics, so that Deloitte can begin to develop an audit plan.

Mr. Chung noted that after Deloitte puts together, and the Commission accepts, the first year audit plan, the Commission will need to determine whether it wishes to exercise its contractually provided option to retain Deloitte to perform the first year audit using the agreed-upon audit plan. Mrs. Corbett noted that there will be an additional cost if Deloitte is asked to perform the first year audit. Mr. Borden suggested that even if an internal auditor is in place, RSIC may nevertheless want to utilize the services of a third party, given the scope of the audit work which the Committee had been discussing. Mr. Williams asked whether the Commission has the right to adjust the scope of the existing engagement with Deloitte. It was reiterated that, under the terms of the existing contract, the Commission has the right to decide to use Deloitte to execute the first year audit plan. As to other adjustments in scope, Mrs. Corbett said that staff would need to consult with counsel.

Mr. Borden reiterated that Mr. Chung will present a summary of the Risk Assessment at the Commission meeting on September 15.

VII. Adjournment - Mr. Gillespie made a motion to adjourn. Mr. Williams seconded and it was approved unanimously.