South Carolina Retirement System Investment Commission
Audit Committee Meeting Minutes

Thursday, May 14, 2015

Capitol Center
1201 Main Street, 15th Floor
Columbia, SC 29201
Meeting Location: Presentation Center and Teleconference

Committee Members:
Mr. Allen Gillespie, Chairman
Mr. Edward Giobbe
Ms. Peggy Boykin

Others present for all or a portion of the meeting on Thursday, May 14, 2015:
Betsy Burn, Gail Cassar, Andrew Chernick, Dori Ditty, John Farmer, Robert Feinstein, Scott Forrest, Monica Houston, Hershel Harper, Mike Hitchcock, Eric Nelson, and Ron Wilder (via conference call) from the South Carolina Retirement System Investment Commission (RSIC); Melinda Al-Hasan from the State Treasurer's Office; John Page from the Public Employee Benefits Authority; Wayne Pruitt and Donald Tudor from the State Retirees Association of South Carolina.

I. **Call to Order:** Chairman Allen Gillespie called the meeting of the RSIC Audit Committee (Committee) to order at 1:07 p.m. The agenda was unanimously approved.

II. **Approval of Minutes:** The minutes of the meetings of February 10, 2015 were carried over without objection.

III. **Audit Committee Follow-up:** Ms. Monica Houston, Chief Audit Officer, reported on the items currently open on the Audit Committee Follow-up Tracking Log. She indicated that there were five items currently open two of which were added at the February 10th meeting. Ms. Houston preceded into discussion of the two newly added items, noting the one relative to Conifer reporting appeared to have been addressed in the Conifer presentation to the Commission on April 23rd and asked if there were still concern for the Audit Committee. Mr. Gillespie suggested that the Conifer item be closed out at the committee level. Ms. Houston noted that the other new open item concerned the compensation consultant. Mr. Hitchcock reported that the contract had been awarded to Towers Watson and that a compensation plan would be ready for the September Commission meeting. Mr. Gillespie requested that the item remain open.

Ms. Houston continued the discussion of the open items focusing on the two items noted as being addressed as part of the action plan for the Funston Fiduciary Review. Andrew Chernick, Director of Operations and Operational Due Diligence indicated that he still was working on the item relative to statutory requirement for 70% equity allocation and that the Commissioner standard reporting request item would be always ongoing. Upon inquiry by Ms. Boykin, further discussion relative to the detailed nature of the statutory requirement for 70% equity allocation ensued wherein Mr. Gillespie, Mr. Giobbe, Ms. Gail Cassar, Audit Consultant, and Mr. Eric Nelson, Director ERM and Compliance joined in. Through the discussion it was determined that the pertinent item of concern was the utilization of cost basis versus market basis in determining compliance with the 70% equity allocation statutory provision.

Mr. Gillespie added that perhaps the concept of leverage should be considered in the calculation to which a separate discussion involving such ensued with Ms. Boykin and Mr. Nelson participating. In the end agreement was made that the concept of leverage was a separate concern to be dealt with at a future time. Mr. Michael Hitchcock joined the discussion requesting focus on what he saw as the issue which was how to test compliance with the cost basis provision for calculation as stated per the SIOP. Ms. Houston noted that use of the cost basis versus the market basis in the calculation as per the SIOP was actually the concern identified by Internal Audit not the testing of compliance with the cost basis. The Committee agreed that market basis needed to be used and a motion was made by Ms. Boykin and seconded by Mr. Giobbe that the Audit Committee recommend to the full Commission that the SIOP be revised to reflect utilization of the market basis for determination of the 70% equity allocation; the motion passed unanimously.

Ms. Houston stated that this item would be closed out and a new one detailing the recommendation would be opened. Discussion relative to timelier, standard reporting was held wherein Ms. Boykin indicated that she agreed that such would be ongoing in nature unless there was some specific standardized reporting the Committee desired. Ms. Houston provided an explanation as to the purpose and background of the Follow-up Tracking Log, indicating that the close out of this item at the Audit Committee level would not have an effect on the individual audit recommendation tracking done as part of the Internal Audit process and hence the resolution of the item and implementation of management’s action plan would still be monitored. The Committee agreed to close out the item.

Ms. Houston noted that remaining open item was the investment and operational due diligence item that resulted from an inquiry by Mr. Giobbe and a presentation was scheduled during the current meeting to address such.

IV. Legislative Audit Council (LAC) Update: Mr. Chernik reported on the present status of the LAC audit of which RSIC was notified of in March 2015. He noted the completion of survey work and creation of a formal audit plan with fieldwork scheduled to be complete in July 2015 and an audit publication date of September 2015. Mr. Hitchcock noted that RSIC is working closely with PEBA to assist LAC. Mr. Gillespie asked if staff knew the specific nature of the LAC inquiry. Ms. Boykin stated that she reviewed the LAC letter and noted that it was inconclusive. Mr. Gillespie asked if this effort would be similar to the recent one in Utah. Mr. Hitchcock noted that the approach appeared very holistic and in search of common issues facing the defined benefit plans universally and the sufficiency of our reaction to such. Mr. Gillespie asked about the likelihood of headline risk, and Mr. Hitchcock said such was difficult to determine but thought that the Utah response was a good one. Mr. Gillespie asked for more detail on the Utah response. Mr. Hitchcock said that he would provide it for Mr. Gillespie.

V. ERM and Compliance Update: Mr. Nelson reported that he had spent much time on policies and governance and made several adjustments and suggestions that have been submitted to management and legal. He specifically noted he revised the Employee Handbook and had provided such to the Director of Human Resources. He said that he has had initial orientation meetings on risk management with top two levels of management and continues to do so. He noted his desire to offer to the committee a biennial compliance, June 30 and December 31, report overview in table format.

Ms. Boykin asked for an explanation of the Investment Manager Completeness Reviews. Mr. Nelson replied that it is a compliance document that confirms the items required prior to an investment coming before the Commission. Mr. Gillespie added that he had prompted the creation of this protocol in order to create a set of basic items that everyone could agree upon especially from a custodial perspective.

Mr. Giobbe asked about the Iran and Sudan policies. He asked about the practical effect of those and how far down the line does the legislative restriction go. Mr. Robert Feinstein, Chief Legal Officer noted that staff and counsel is working on a set of recommendations to implement this legal mandate and that such would be presented to the Commission in the very near future. Mr. Giobbe asked about the level of difficulty of implementing the law giving the number of managers and the focus of responsibility. Ms. Houston noted that there is an upcoming audit, Investment Approval and Funding Audit that will address this item as part of its scope. Mr. Giobbe further inquired about the RSIC placement agent policy and if it should be reviewed. Mr. Chernick noted that the policy is approved as part of the SIOP.

Mr. Nelson reviewed the ERM project plan provided as part of the meeting materials noting that the Funston Review deadline for concerns in this area is December 31, 2016 for which he has no current concerns in meeting. Mr. Gillespie asked about the strategic planning meeting and if more definitive ideas about risk ownership would be available by then for decision-making purposes. Mr. Nelson replied that he preferred to not address those issues at the strategic planning meeting but rather with individual commissioners; indicating that he would rather work on the policy front first. In response, Mr. Gillespie inquired as to whether the plan timeline should be extended and Mr. Nelson agreed. Mr. Gillespie asked about the risk potentially owned by the Commission itself and if that shouldn't be addressed at the strategic planning meeting. Mr. Hitchcock noted that RSIC as a whole needs to set its lines of jurisdiction and that staff will have recommendations on the topic at the strategic planning meeting. Mr. Nelson noted that the convergence of risk management and strategic planning was included in his timeline as occurring in 2016.

Mr. Nelson reviewed the risk framework and noted that he and staff have agreed upon its contents and format. He then discussed the inherent risk assessment based upon the RSIC business model and its potential usefulness in forming the audit plan for the coming year. Mr. Giobbe asked for clarification on the classification of risk within the assessment. Mr. Nelson expounded upon the classifications within the framework. Mr. Gillespie asked when the committee might expect to see the quantification of the quantifiable risks. Mr. Nelson replied that such an effort might be an overburden on the current staff. Mr. Gillespie noted that some things are measurable, and Mr. Nelson agreed that the simplest performance measures are quantifiable and can be offered as a risk narrative. Mr. Nelson further noted that as he works through controls he will be looking for risk indicators but that such effort is a little further out on the risk plan.

VI. **Internal Audit Update:** Ms. Houston discussed the status of the approved audit plan. She noted that staff is on course to significantly complete the plan on time. She stated that an engagement letter had been received from Elliott Davis on the ITGC and that they could be on site as early as May 25th with work expecting to be completed no later than June 30. Ms. Houston noted that work on the engagement letter for Clifton, Larson, Allen (CLA) continues and that a setback in the progression was experienced since the report given at the prior AC meeting. Ms. Houston indicated that CLA believed the work could be done by the end of June but that she thought the work would go past June 30th but would not exceed July 31. Ms. Houston indicated that the Performance Reporting audit was in the reporting stage and should be available at the next meeting. She noted that the Agency Relationships audit had been on hold but had been restarted and that HEK was cooperating with the review of their services. Ms. Houston again noted that the goal of significant completion of the audit plan would be met.

Ms. Houston noted that the amount of the Elliott Davis engagement does not exceed the amount identified in the resources section of the audit plan but that she was working with executive management to manage any potential budget concerns.

Ms. Boykin asked if there was an update of the audit schedule. Ms. Houston replied that due to the time constraints of the meeting she did not provide the detailed document but that she would provide it following the meeting. Ms. Boykin asked how long the CLA engagement negotiation had been proceeding, and Ms. Houston noted that it had been since August 2014. Ms. Boykin inquired about the parameters of the engagement and the challenges, and Ms. Houston replied that two things had occurred. She said that the State Auditor wanted to combine some of their work with RSIC. CLA had difficulty coming together with the State Auditor on agreed upon procedures. She noted also that CLA had not done the proper set of agreed upon procedures for RSIC and that RSIC staff had to do that. Ms. Houston said that she worked on both sets of procedures (RSIC and State Auditor) and sent them to CLA and that she now is waiting upon a response from CLA. Ms. Boykin asked if the State Auditor had asked RSIC to do thing outside of its ability. Mr. Chernick replied that they failed to fully understand the proper parameters relative to RSIC. Ms. Boykin asked if all of the agreed upon procedures other than those for the valuation initial due diligence and ongoing due diligence came from the State Auditor and if that document could be provided. Ms. Houston noted that the biggest problem lay in CLA's lack of response to RSIC along with the lack of the State Auditor understanding the nature of RSIC operations. Mr. Giobbe asked why this cannot be simply brought to conclusion, and Ms. Boykin offered to reach out to CLA and the State Auditor. Mr. Gillespie asked if the committee should engage. Ms. Boykin asked if the agreed upon procedures are settled for RSIC. Mr. Chernick replied that they are much improved. Ms. Boykin asked to look at them. Mr. Giobbe asked if the problem lay with the State Auditor, and Ms. Houston said that was the initial problem. Ms. Houston noted also that the level of RSIC involvement was to be minimal. Ms. Boykin suggested that she and Mr. Hitchcock should talk with the other two parties to expedite the process. Mr. Gillespie agreed to authorize it from the committee. Mr. Giobbe agreed.

VII. **2015-16 Internal Audit Risk Assessment:** Ms. Houston noted that this item was a request of Ms. Boykin. She described the process for determining what items are identified for inclusion in the audit plan. Ms. Boykin noted that she wanted to ensure that her understanding of risk assessment was full and clear and that she had met with Ms. Houston on the subject. Ms. Boykin noted that she had a different view as to how risk was categorized and quantified and that she asks that the Audit Committee hear from everyone. She stated that she thinks risk is what about the operation keeps management up not that we're going to audit this particular item because it is high risk and how do you build in the fact that a particular area has been audited previously and the results of that audit. Ms. Boykin further stated that everything in the organization should be audited at some point in time but that if we spend our resources auditing the same thing every year that we will have big holes in our audit coverage of the organization and that hearing from everyone would aid in determining the audit plan. Mr. Gillespie noted that consideration of management's view of risk as well as that of prior audit experience has always been the case in determining the audit plan. He added that the Committee itself was the owner of the audit plan. Ms. Houston stated that she performs a risk assessment every year and that she has obtained management's view point of risk as a part of the process each year. She further stated that although she obtains management's view point on risk, she must determine risk on an independent basis as per professional standards. Ms. Houston elaborated upon the detailed process for determining various areas of risk and noted that such was done in accordance with professional standards of prioritizing risks and focusing resources on areas of high and moderately high risk. Mr. Gillespie noted that the final audit plan is the responsibility of the Committee not Ms. Houston and that such is done to obtain independent assurance. Mr. Chernick interjected that subjectivity is inherent in any risk assessment and that there are things that he agrees and disagrees with

In the interest of time, Mr. Gillespie asked Mr. Chernick for his top three priorities upon which he would focus audit resources. Mr. Chernick mentioned contract compliance in co-mingled investments. He disagreed that operational due diligence is high risk because he believes that RSIC is best in class when it comes to practices in this area. Mr. Chernick said that initial due diligence ranks high on the list. Ms. Boykin asked about derivatives or style drift as investments, and Ms. Houston noted that derivatives is on the list but based upon risk inputs did not raise to a high risk level which matched up with management's view. She indicated that as part of her process in assessing risk she matches up her determination of risk for areas with the views of management and to the extent there is a great amount of variance attempts to reconcile such. Mr. Gillespie noted that the Board may also perceive risk differently and desire assurance. He stated that just because management was comfortable with the controls in place did not mean the Committee was and hence the need to look at an area from an assurance perspective. Ms. Houston agreed and noted that inherent risk is that risk which exists in the absence of controls. She expounded upon the role of internal audit is to provide objective assurance for the Committee as well as other stakeholders and to provide consulting services that add value to the organization. Ms. Houston indicated that the disconnect is management's view of value and that assurance is not viewed as adding value. She further noted that utilization of resources is based upon the risk appetite set by the Audit Committee and that currently such was to audit all items that were identified as high or high moderate on an annual basis, any items identified as moderate every other year, and items identified as low on a 3 – 5 year cycle. Ms. Houston stated that it is the risk appetite and availability of resources that determines the degree of audit coverage, noting that the Committee has the ability to change their risk appetite.

Ms. Boykin noted that the committee should engage in further discussion about the plan and its reflection of their view of inherent risk. She noted that fees, for instance, have been audited annually, and by different entities, and that it perhaps no longer belongs on the list given the limited resources of RSIC internal audit. Mr. Gillespie noted that fees actually reflected political and other risk and that management made it a key issue. Ms. Boykin noted that CEM did a great job in its report on SC RSIC and that the focus on fees had been good but that the focus needs to shift. Mr. Gillespie agreed, and Ms. Houston said that residual risk is what the plan is built off of and that the process considers many factors that lower inherent risk including previous audit experience. She stated that if the controls in the fee process remain stable and are determined to be good then its residual risk should move to moderate and based upon the current risk appetite fees would be looked at on a 2 year cycle. Ms. Houston noted that she has not received notice of any disagreement from management on the rating of particular risk inputs for any processes but rather it seems management's concern is that they are comfortable with the controls so they don't think there is risk. She reiterated that her role within the organization is to provide objective assurance in the areas of high risk and moderate risk as determined by the Audit Committee and stated that if the Committee would like to change their risk appetite they were within their right to do so. Ms. Houston further noted that the risk assessment and audit plan are: prepared in conformity with professional practices, that such was reviewed by Funston during the fiduciary review, and that no concerns are recommendations were noted as a result of that review.

Ms. Boykin asked Ms. Houston for what she thought were the three top priorities for internal audit. Ms. Houston replied that it is not what she thinks but rather what the results of the risk assessment are that drives the priorities and cautioned that the results presented were subject to the completion of open audits. She noted that operational due diligence, investment funding and approval, and valuation are noted as inherently high risk. Ms. Boykin asked Mr. Hitchcock for his top three priorities for internal audit. In response he provided his overall thought first which was that the audit plan be aligned with the available resources. He added that he agrees and understands Ms. Houston's position on the ODD but thought that in any of these the Audit Committee owns the plan and that the Committee could accept or concentrate on given the resources available and that operational due diligence need not necessarily be focused upon. He mentioned changing terms and conditions in contracts as having an organization-wide impact. He also mentioned compliance within co-mingled accounts. He added that testing the reliance on outside service providers, such as Conifer, might be an appropriate context for reviewing fees in the future.

Mr. Gillespie fee analysis originally rose to high importance because of its inclusion in the CAFR, albeit in unofficial form. Additionally, he noted that the process for fees continues to change each year. Ms. Houston noted also that there have been internal audit findings in that area in addition to the continuous changes in the process.

Mr. Gillespie relinquished the chair to Ms. Boykin and departed the meeting around 3:10 p.m.

Ms. Boykin reiterated her need to have such background information and discussion prior to approving an audit plan to which Mr. Gillespie replied that ultimately the Committee owns the process because Internal Audit's primary role is that of providing assurance back to the Board. Ms. Houston noted the delegation of responsibility to her in the performance of the risk assessment and reiterated that it is her responsibility to perform and provide such in accordance with professional standards. She shared that in a recent quality review performed on another pension system, one of the findings was that they were not appropriately providing audit coverage to their high risk areas due to lack of resources. She reiterated that her job is to present what the best practice is and to make recommendations based upon work performed using professional practice. Mr. Giobbe noted that although the previous discussion was good, there was a tremendous amount of time and attention focused on procedure and he prefers that the Committee look at the bottom line.

Ms. Boykin asked Mr. Harper for his thoughts on organizational risk. Mr. Harper replied that co-mingled structures and their compliance deserve scrutiny. He added that SMAs, internal management and the overlay all reflected lower risk items. He said that operational due diligence itself actually lowers overall risk.

Allen Gillespie rejoined the meeting via conference call.

Ms. Boykin asked that Ms. Houston share her audit plan proposal with senior management to elicit their feedback prior to bringing it to the audit committee for approval.

VIII. RSIC Operational Due Diligence (ODD) Presentation: Mr. Scott Forrest, Operational Due Diligence Officer reviewed the premises and practices of ODD. He discussed the areas that he covered when reviewing a potential investments. He noted that the function is not a forensic audit and not a valuation effort. He discussed the volume of work performed during his tenure. He reviewed other services provided to various RSIC departments and plans for future products from his office. He reviewed his professional background and experience.

He reviewed some of the details of any particular audit including questions asked and documents requested.

Ms. Houston asked if Mr. Forrest adds value to HEK when reviewing a co-investment, and he replied yes.

Mr. Gillespie asked Mr. Forrest reviews the personnel and litigation history of a potential investment partner and if he spot checks the information and data provided for its accuracy, particularly concerning the potential partner's auditors. Mr. Forrest said that such auditor review is difficult due to SC indemnification law. Mr. Forrest noted HEK performs background checks, and Mr. Chernick added that it is not the case on every single manager but on hedge funds, managers with initial product offerings and when the client has concerns. Mr. Gillespie noted that while a firm may pass a review that some individuals may have difficult histories. Mr. Forrest noted that the regular questionnaire asks about previous or ongoing litigation with the firm or individuals. He added that this line of inquiry will evolve.

Mr. Forrest reviewed what he looks for in an ODD report as indicators of potential problems. He discussed the primacy of front-end due diligence and the importance of ongoing due diligence, and described the latter process. He then discussed the due diligence questionnaire (DDQ), particularly as it relates to fees and expenses and the pointed questions included in the DDQ.

IX. Executive Session to discuss personnel matters pursuant to S.C. Code Ann. Section 30-4-70(a) (1): The Committee unanimously voted to enter executive session at 4:36 p.m. to discuss personnel matters. In advance of the meeting, Ms. Houston requested direct time with the Audit Committee without RSIC management present which was not granted at the time of the meeting upon the insistence of Ms. Boykin. The Committee proceeded to meet with RSIC management (Mike Hitchcock, John Farmer, and Robert Feinstein) without the Chief Audit Officer present. No actions were taken.

X. Adjournment: Acting Chairman Boykin adjourned the meeting at 5:21 p.m.

[Staff Note: In compliance with S.C. Code Ann. §30-4-80, public notice of and the agenda for this meeting were delivered to the press and to parties who requested notice and were posted at the entrance, in the lobbies and near the 15th Floor Conference Room at 1201 Main Street, Columbia, SC, at 2:11 p.m. on May 13, 2015.]