

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

November 2, 2012

**SC Retirement System Investment Commission
1201 Main Street, 15th Floor
Columbia, SC 29201
Meeting Location: Presentation Center**

Committee Members Present:

Mr. Allen Gillespie, Chairman
Mr. Reynolds Williams, Vice Chairman

Others present for all or a portion of the meeting on Friday, November 2, 2012:

Geoff Berg, Andrew Chernick, Sarah Corbett, Robert Feinstein, Hershel Harper, Monica Houston, Adam Jordan, James Manning and Nancy Shealy from the South Carolina Retirement System Investment Commission (“RSIC”); Sue Moss from State Auditor’s Office; Michael Chung (via telephone) from Deloitte and Touche (“Deloitte”); Mr. Thomas Rey (via telephone) from CliftonLarsonAllen; Clarissa Adams, Bill Leidinger, and the Honorable Curtis M. Loftis, Jr. (observer) from the State Treasurer’s Office; Bill Blume (observer), Tammy Nichols and Faith Wright from the South Carolina Public Employee Benefit Authority (“PEBA”); Jim Holly from the Comptroller General’s Office; Wayne Pruitt from the State Retirees Association.

- I. **Call to Order:** Mr. Allen Gillespie called the meeting of the RSIC Audit Committee (“Committee”) to order at 10:18 a.m. Mr. Gillespie asked for a motion to approve the agenda. Mr. Reynolds Williams (via telephone) made a motion to approve the proposed agenda. Mr. Gillespie seconded the motion, which was passed unanimously.

- II. **Approval of Minutes:** Mr. Gillespie commented about the revisions to composition of the Audit Committee, stating that the revisions would require policy changes at the Commission level and that he would be making those motions in the Commission meeting next week. Mr. Gillespie asked for a motion to approve the minutes from the Committee meeting on September 18, 2012. Mr. Reynolds Williams made a motion to approve the Committee meeting minutes from September 18, 2012, which was seconded by Mr. Gillespie and approved unanimously.

- III. **Approval of 2012 Audit Committee Meeting Schedule:** Mr. Gillespie read aloud the proposed Audit Committee meeting schedule for CY 2013. Mr. Gillespie requested a motion to approve the proposed schedule, which was made by Mr. Williams. Mr. Gillespie seconded the motion and it was unanimously approved.

- IV. **Audit and Compliance Update**

Summary of Audit Activities: Mr. Andrew Chernick, Director of Internal Audit & Compliance, summarized the agenda for the audit activities as outlined below. Additionally, he made note of a

recently completed audit initiative to establish and communicate a Whistleblower email notification process.

- a. **State Auditor Agreed Upon Procedures Report:** Ms. Sue Moss, Audit Manager with the State Auditor's Office, explained the scope of the work performed for the Agreed Upon Procedures engagement indicating that such was limited to a review of the organization's cash in-flows and out flows. She stated that special testing of the investment fees was also performed. Ms. Moss reported that there was one finding as a result of the procedures performed this year due to the payroll for one employee not being timely approved. A discussion took place as to the size and determination of the testing sample (obtained for the testing of the investment fees), the possibility of obtaining the details of the sample used, and whether the testing could become an annual process. Mr. Gillespie made additional inquiry relative to certain controls within the process; Ms. Moss, Nancy Shealy, Chief Legal Counsel, and Sarah Corbett, Deputy Chief of Staff responded to the inquiry providing clarification. Ms. Moss concluded her report with the assistance of Monica Houston, Internal Audit & Compliance Officer by discussing RSIC's management action plan to address the concern.

Mr. Williams arrived to carry out the remainder of the meeting in person at 10:30 a.m.

- b. **Treasurer's Letter:** Following is a brief synopsis of the discussion relative to the Treasurer's letter dated October 11, 2012 and regarding FY 2012 Audit of SCRS. Due to the nature and sensitivity of this topic the discussion was very in-depth and lengthy; see pages 16 - 56 of the excerpted transcriber recording as attached for full details. In response to a question from Mr. Gillespie concerning the Treasurer's letter, Mr. Thomas Rey of CliftonLarsonAllen stated that in regards to his audit the management at the South Carolina Retirement Systems (currently known as PEBA) is without question considered to be "management" for purposes of representation. He further stated that it would not be imprudent for a representation letter to be made from RSIC management to South Carolina Retirement Systems ("Retirement System"). Ms. Corbett interjected that RSIC was working to provide a management representation letter to Mr. Bill Blume, Executive Director of PEBA. An additional inquiry was made by Mr. Gillespie as to the responsiveness and level of assistance provided by RSIC in support of the issuance of the financial statements. Mr. Rey noted that there were no issues with the 2012 audit and that the obtainment of a memorandum of understanding ("MOU") between the Investment Commission and the Retirement System, alleviated some hesitancy that was experienced in 2010. Upon inquiry by Mr. Williams, Ms. Corbett stated that the MOU was signed in September 2011 and that it contained confidentiality provisions governing the receipt of information by external vendors. Mr. Gillespie made final inquiry as to whether there were any issues related to the 2012 financial statement audit that the Commission needed to address. Mr. Rey responded in the negative.

In response to a question from Mr. Gillespie about his initial reaction to the Treasurer's letter, Mr. Michael Chung of Deloitte pointed out two inaccuracies within the letter. Mr. Chung noted that the scope of the project never changed. Mr. Chung advised the Committee that the Treasurer's letter also inaccurately stated that the audit from Deloitte was "generic". Mr. Chung clarified that Deloitte sought to "provide recommendations for enhancing or improving the existing control environments for the Commission's management consideration", which may have deviated from the traditional audit report. Mr. Chung stated that the RSIC's due diligence and controls were a work in progress and concluded by stating Deloitte's Audit Report simply "reported on the facts".

Upon additional inquiry by Mr. Gillespie regarding his thoughts, Mr. Chung cautioned that the development of a management representation letter to go to the Retirement System not be a perfunctory exercise. He stated that there should be some rigor behind it so that there could be appropriate reliance. Mr. Chung responded to a question, that financial statements were inherently a high risk and that such risk could be lowered with proper controls. In response to a question about the lack of controls in cross trading, Mr. Chung noted the importance of distinguishing primary and secondary actors (actors meaning who controls the initial decisions) and who has the ultimate responsibility for overseeing the plan assets. Mr. Chung suggested the Commission develop a program to determine whether an investment was a straight buy/sale or cross trade, and review any other aspects of the process that the Commission is not primarily responsible. Mr. Chernick interjected that the investment team incorporated the reviewing of cross trades and trade allocation policies in the new due diligence procedures. The plan was to get the process implemented, and then determine best practices for the future.

Mr. Gillespie asked Mr. Chung and Mr. Rey to speak to the expected controls over valuations related to external managers. Mr. Chung responded that it was a coordinated effort across three areas: 1) Clarification of tasks external managers perform 2) A need to have controls in place over the information 3) Communication between the Retirement System and Investment Commission. Mr. Rey agreed with Mr. Chung's explanation and provided details to support their agreement. Mr. Rey summarized his response by stating that they do a risk assessment, consider internal controls, and, to the extent controls cannot be relied upon, increase the amount of testing like they did in the case of the current audit. In response to an additional inquiry, Mr. Rey indicated that it is rare that Clifton Larson Allen does not have recommendations for enhancement external vendor or alignment with best practices in regard to due diligence.

Mr. Gillespie made inquiry regarding contractual inhibitions to RSIC's ability to share information across the environment and across agencies. Mr. Williams reiterated that the MOU from October 2011 eliminated any barriers of sharing information to complete the annual financial statement audit.

Ms. Houston asked Mr. Rey to clarify why 100 percent population was considered because it was not a typical practice. Mr. Rey responded that Clifton Larson Allen carved out the entire population of non-custodial assets and tested 89.4 percent of the non-custodial dollars for both existence and valuation. Mr. Rey noted that the Treasurer's letter was misleading in stating that management should be performing all of their own valuations, as doing such was virtually impossible. Mr. Williams asked if the valuation methodology described in the contracts was clear and if the work could be duplicated given enough resources, to which Mr. Rey responded that subsequent AICPA clarifications indicated that reliance can be placed on the audited financial statements for the funds and underlying securities and that reasonable assumption can be made that professional standards were followed in the performance of such audits.

Discussion ensued regarding the identification of red flags that indicated a potentially fraudulent situation in the valuation of the assets. Thereafter, Mr. Williams noted page 11 of the Treasurer's letter and asked if there was anything in Deloitte's risk assessment reports that inhibited the completion of the financial statement audit as scheduled. Mr. Chung responded that their concerns were being properly addressed. Mr. Rey's and Mr. Chung's participation concluded.

Mr. Gillespie made a motion that the management letter to PEBA be formally recommended to the entire Commission at their meeting the following week. Mr. Williams seconded the motion and it was unanimously approved.

- c. **Alternative Investment Valuation Procedures:** Mr. Chernick summarized that the Internal Audit and Compliance department was working with the Retirement System and the Investment Commission to ensure the continuation of improvements to alternative investment valuation monitoring procedures. Mr. Chernick responded to a question, that in viewing the strategic partnerships as fund of funds, we would need only to gain comfort that the strategic partnership has appropriate controls to use the audited NAVs of the underlying funds. Mr. Chernick stated that a main initiative was to work with the Retirement System to formalize the valuation policies and procedures by January 2013 in order to assist with the reduction of testing in the future. Mr. Chernick mentioned that another initiative in the works was to obtain a copy of all the manager's most current valuation policies and procedures. He explained that while gathering this information, more questions would be asked of the managers pertaining to valuation, such as proper calculations or any administrator changes. The initiative is expected to be completed by December 2012. The next initiative Mr. Chernick mentioned was standardization of ongoing due diligence procedures scheduled to be approved by Mr. Herschel Harper, RSIC's Chief Investment Officer ("CIO"), by November 15, 2012. Details were discussed on the depth, organization, and documentation of standardization procedures going forward as well as the role of in Internal Audit and Compliance. Mr. Chernick stated this information was pertinent to the valuation topic because as a part of the new due diligence reports, the valuation policies and procedures will require back office reviews to be performed by a manager, thus ensuring open communication throughout the entire process.

- V. **Approval of 2012-13 Audit and Compliance Plan:** Ms. Houston presented the proposed audit plan for the time period November 2012 through June 2013. Ms. Houston noted that the plan included two investment valuation projects; the investment valuation policy and the valuation of investments. Ms. Houston made note of the number of hours for administrative support of the Audit Committee and for management requests. Ms. Houston confirmed that all hours would be monitored on an ongoing basis and any concerns communicated as needed.

Ms. Houston stated that a consolidated risk assessment was performed that gave consideration to input from management, the Retirement System, and Deloitte. She spoke in detail regarding the procedures performed in the identification and ranking of the organization's risk. Ms. Houston identified the four different risk continuums were operational, financial, strategic, and compliance, pointing out that the level of risk would revolve and continuously change. Ms. Houston noted that as RSIC aged as a business, the risks should drift left. Ms. Houston outlined in detail the five areas of the risk management process and the differences between audit and compliance, and stated the overall goal for the future was for more time to be allotted for audit, as opposed to consulting; see pages 81 – 88 of the attached transcript for detailed information on the distinction between Audit, Compliance, and Consulting services. Ms. Houston specified for the remaining fiscal year 2013, the service allocation would include: five percent for requests, 13 percent for consulting, 25 percent for compliance, and 57 percent for audit. Mr. Williams questioned why the "compliance policy and procedures" line item in the plan did not get a risk evaluation, to which Ms. Houston responded it was developing a framework.

Mr. Williams made a motion to adopt the plan and present to the Commission. Mr. Gillespie seconded the motion and it was approved.

- VI. Review of Risk Assessment Dashboard:** Mr. Chernick updated the Committee on the Deloitte Risk Assessment Dashboard and noted the reformatting changes. Mr. Chernick noted that three tasks were completed. Mr. Chernick specified the tasks currently in progress with the first being the development of an operational infrastructure. Ms. Corbett stated that the timeline for the completion of this task was at a standstill due to a protest from a vendor. Mr. Chernick noted the remainder of the tasks still in progress. Mr. Chernick concluded his overview by stating that Mr. Adam Jordan, RSIC's Interim Chief Executive Officer ("CEO") would now oversee strategic partnership initiatives of reporting and governances.
- VII. Executive Session to discuss investments of other financial matters pursuant to S.C. Code Ann. Sections 9-16-80 and 9-16-320:** Mr. Williams commented that he was pleased with the presentations and reports given by Ms. Houston and Mr. Chernick, and then made a motion to adjourn the meeting and go to Executive Session. The motion was seconded by Mr. Gillespie. Upon returning from Executive Session, Mr. Williams noted that no action was taken.
- VIII. Adjournment:** There being no further business, on motion duly made and seconded, the meeting was adjourned at 12:35 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, on October 30, 2012.]

Page 13

1 that's where -- that's how the authority is
 2 granted for administrative payments.
 3 THE CHAIRMAN: Okay.
 4 MS. SHEALY: It originated through the agency head -
 5 -
 6 THE CHAIRMAN: Head, right.
 7 MS. SHEALY: -- because most of the statutes and
 8 provisions of the appropriations act talk in
 9 terms of agency head. And so then it flows,
 10 the delegation flows down from that. And SCEIS
 11 plays a big part in this, too, because in order
 12 to implement or process a lot of these things,
 13 SCEIS already has that built in. And of course
 14 SCEIS is the electronic accounting system that
 15 we have now. So some of that's already built
 16 in.
 17 MS. MOSS: It's the separation of duties and that
 18 kind of is built into the SCEIS system.
 19 THE CHAIRMAN: Right. But it sort of implicitly
 20 follows a job description then?
 21 MS. CORBETT: Yes, I think that's kind of the
 22 official delegation of authority is in a
 23 position description and a planning document
 24 where we set out the expectations for
 25 employees.

Page 14

1 THE CHAIRMAN: Okay. And that would be consistent
 2 with y'all's expectations?
 3 MS. MOSS: Exactly.
 4 THE CHAIRMAN: Reynolds, you have any questions on
 5 this?
 6 MR. WILLIAMS: No.
 7 MS. MOSS: Did he get to see the report?
 8 THE CHAIRMAN: Have you seen the report?
 9 MR. CHERNICK: It was uploaded.
 10 THE CHAIRMAN: It was posted.
 11 MR. CHERNICK: Yeah, it was posted.
 12 MR. WILLIAMS: Yeah, I've seen it.
 13 MS. MOSS: I think it looks like a good result.
 14 THE CHAIRMAN: Okay. If there are no further
 15 questions, do we have to make any sort of --
 16 adopt this or accept this or anything, or is it
 17 just automatically in the record?
 18 MS. MOSS: It's done. It's final. They responded
 19 to the finding.
 20 MR. CHERNICK: Yeah, there was a management response
 21 which was included in the --
 22 MS. MOSS: It is included in here.
 23 MR. CHERNICK: -- put in the final report. So I
 24 think the one finding was remedied.
 25 MS. MOSS: Right. I think they actually had a

Page 15

1 learning curve with this. They realized that
 2 one of the reports that they were using was if
 3 somebody was in terminate status was it showing
 4 up on the report and that's how it slipped
 5 through their process for detecting these
 6 things.
 7 MS. HOUSTON: They had the appropriate controls as
 8 it was, but the way SCEIS delegates their
 9 reports the population which it was pulling
 10 from would not pull from terms. So this person
 11 actually termed and then was put on as a new
 12 employee and kind of fell through the cracks on
 13 that. But we now have a report and a process
 14 in place that would mitigate that from
 15 happening in the future.
 16 THE CHAIRMAN: You don't need any -- we don't need
 17 any motion from that committee?
 18 MS. HOUSTON: No, not at all.
 19 MS. SHEALY: I think for purposes of the minutes
 20 y'all are receiving this report as information.
 21 THE CHAIRMAN: Okay. All right. Thank you very
 22 much.
 23 (Mr. Williams entered the room.)
 24 MR. WILLIAMS: I said that but the elevator is the
 25 only person who heard it.

Page 16

1 THE CHAIRMAN: Okay. Let the minutes reflect that
 2 Mr. Williams is now in person and fixing his
 3 coffee but within earshot. Next item is the
 4 Treasurer's letter, which was addressed to Mr.
 5 Blume and Mr. Jordan dated October 11th of
 6 2012. Decided to bring this up only because it
 7 does touch on issues relevant to the activities
 8 of the Audit Committee and of the Audit -- of
 9 the Investment Commission, as well as other
 10 agencies with which we need to interact. And
 11 I think it's incumbent upon this Committee to
 12 make sure in our communications with those
 13 other bodies that we're aware of our duties and
 14 need to facilitate proper interaction. So I'm
 15 not sure if Deloitte, I doubt y'all have this
 16 in your possession or have seen it and I don't
 17 know about you, Mr. Rey. Are either of y'all
 18 familiar with the letter to which I'm
 19 referring?
 20 MR. CHUNG: Yes, I -- this is Mike Chung from
 21 Deloitte --
 22 MR. WILLIAMS: Yeah, I direct -- I didn't know Mike
 23 was on the phone. I asked them to send one to
 24 Mike.
 25 THE CHAIRMAN: Okay. And what about you, Mr. Rey,

Page 17

1 are you familiar with the letter?
 2 MR. FEINSTEIN: He was cc'd on the letter.
 3 THE CHAIRMAN: Oh, he was cc'd on the letter. Okay.
 4 So maybe I can just start with you, Mr. Rey,
 5 you know, just kind of laid out, some of the
 6 highlights of the letter basically have to do
 7 with the financial statements as well as who
 8 should properly be defined as management and
 9 take responsibilities for those. There's
 10 questions regarding sort of valuations and our
 11 obligations under it in terms of testing
 12 valuations. There's some comments, it's a
 13 rather lengthy letter, sort of about the nature
 14 of the Deloitte engagement. So if I can kind
 15 of start initially, if you are familiar with
 16 the letter just I do have specific questions,
 17 but kind of your initial response to it as it
 18 relates to the Investment Commission, our
 19 responsibilities. I would say first kind of
 20 focus on the issue of just management
 21 representations, whether best practices would
 22 have us developing a management representation
 23 letter from our side that would be delivered to
 24 the Retirement System or PEBA I guess at this
 25 point, PEBA. So just if you can address that

Page 18

1 point first and -- because I believe a lot of
 2 the others will flow from that.
 3 MR. REY: Okay. Well, I don't think there's any
 4 question who management is in regards to my
 5 audit, and that would be management at South
 6 Carolina Retirement Systems. So I don't think
 7 it's imprudent for a representation letter to
 8 be made from the Commission to the Retirement
 9 System. But in the case of the audit, from
 10 auditing the financial statements of South
 11 Carolina Retirement System and the management
 12 of the Retirement System is who takes
 13 responsibility for those financial statements.
 14 THE CHAIRMAN: Okay.
 15 MS. CORBETT: And, Mr. Gillespie, if I could just
 16 interject. We are working on a management rep
 17 letter to provide to Mr. Blume.
 18 THE CHAIRMAN: Sort of related to that, has there
 19 been a case or is there any information that in
 20 order for them to take on that responsibility
 21 that they have not gotten from this agency?
 22 MR. REY: You mean have they been -- has there been
 23 some sort of limitation in their ability to
 24 take that responsibility?
 25 THE CHAIRMAN: Yeah, it was my understanding, and I

Page 19

1 obviously wasn't there, but maybe at a PEBA
 2 Board Audit Committee meeting that there was
 3 some question about I guess some staff at the
 4 Commissions, you know, representation or
 5 ability or willingness to provide information
 6 at some point in time. And I may not be doing
 7 it justice, this is just kind of hearing. But
 8 is the Commission providing all the necessary
 9 information necessary for the other side to do
 10 its function and for you to get to a final
 11 financial statement to which you're willing to
 12 sign off on?
 13 MR. REY: Currently, yes.
 14 THE CHAIRMAN: You say currently, has that -- was
 15 that --
 16 MR. REY: I have no issues with '12. I mean, again,
 17 we were retained in 2010, and I don't know that
 18 any auditors had really stepped foot in, but
 19 there was some hesitancy at the Commission in
 20 2010, so I'm going back. As to disclosures of
 21 information, we ultimately signed a memorandum
 22 of understanding, kind of a confidentiality
 23 agreement and were able to access what we
 24 needed to complete our procedures.
 25 THE CHAIRMAN: So were those completed to your

Page 20

1 satisfaction?
 2 MR. REY: Yes, they were.
 3 THE CHAIRMAN: All right. You have additional
 4 questions on that?
 5 MR. WILLIAMS: No, not on that issue.
 6 THE CHAIRMAN: Okay.
 7 MR. WILLIAMS: I presume you're talking about that
 8 memorandum of understanding you signed last
 9 November, right?
 10 THE CHAIRMAN: No, I --
 11 MR. WILLIAMS: Between you and the Retirement
 12 System?
 13 MS. SHEALY: Huh-uh (negative response).
 14 THE CHAIRMAN: Can you -- Mr. Rey, do you mind
 15 clarifying which MOU you're referring to?
 16 MR. REY: Yes, the memorandum of understanding
 17 between the Investment Commission and the
 18 Retirement System.
 19 MR. WILLIAMS: Yeah.
 20 THE CHAIRMAN: When was that executed?
 21 MR. CORBETT: I believe it was last September, I
 22 would have to check the date, but I think it
 23 was last September. And we did put
 24 confidentiality provisions in that MOU just
 25 saying that any external vendors that received

Page 21

1 information through the Retire Systems, that
 2 the Retirement Systems would have to have
 3 appropriate confidentiality language, and the
 4 external audit was certainly, you know, the
 5 main thing that we were interested in
 6 protecting at that time.
 7 MR. WILLIAMS: That's the only question I had on
 8 that issue.
 9 THE CHAIRMAN: Of that issue, okay. I'm trying to
 10 think if there are other question for Clifton
 11 Gunderson on that. Mr. Rey, are there any
 12 issues related to the 2012 which the Commission
 13 needs to provide from your perspective?
 14 MR. REY: No.
 15 THE CHAIRMAN: All right. We want to -- do you have
 16 other questions?
 17 MR. WILLIAMS: No.
 18 THE CHAIRMAN: All right. Should we go to some --
 19 you have --
 20 MR. WILLIAMS: Are we going to hear from Deloitte?
 21 THE CHAIRMAN: Yeah.
 22 MR. WILLIAMS: Okay.
 23 THE CHAIRMAN: Michael, are you familiar with the
 24 letter?
 25 MR. CHUNG: Yes, I am.

Page 22

1 THE CHAIRMAN: Okay. Kind of the same thing, a
 2 little open ended at first, kind of your
 3 initial reaction to it and then I have some
 4 specific questions through it that sort of grow
 5 from it that I'd like to ask of you, but
 6 initially if you are familiar with it, like to
 7 get just kind of your overall reaction to it
 8 and the issues that it addresses.
 9 MR. CHUNG: I mean I can certainly speak to those
 10 aspects of the letter that pertain to the work
 11 that we just recently completed in 2012 as well
 12 as 2011. And, you know, I guess I can start
 13 with starting at the bottom of page 6, the
 14 sentence that starts, Deloitte quickly
 15 determined and then continuing on to the first
 16 sentence on the top of page 7. I just wanted
 17 to clarify some of the facts here. And I think
 18 it's somewhat inaccurate where, you know, it
 19 talks about, you know, that we agreed to change
 20 the scope of this project. I guess it's
 21 referring to the 2012. The scope of the
 22 project was never changed. At the conclusion
 23 of the 2011 project, we went through a
 24 discussion to try to identify those potential
 25 areas that we could look at as the next phase

Page 23

1 of the work. And it was at that time, based on
 2 the risk priority identified during phase one,
 3 and I assume, you know, budgetary constraints
 4 because we couldn't cover everything, that we
 5 decided to look at the due diligence and
 6 valuation and cross trading were added to that
 7 because how they were connected to the due
 8 diligence process. So at no time did we decide
 9 to change the scope of this work, you know,
 10 after we'd commenced it. At the top of page 7
 11 where it talks about, where it mentions the
 12 controls are so weak or non-existent the report
 13 is generic, I think that also is somewhat of an
 14 inaccurate statement insofar as while the
 15 report may not look like a traditional audit
 16 report, internal audit report, rather than
 17 focusing on the gap, what we sought to do was
 18 provide recommendations for enhancing or
 19 improving the existing control environments
 20 for the Commission's consideration to -- you
 21 know, as I mentioned, rather than just simply
 22 belaboring, you know, here are the gaps with
 23 regard to the control environment, we provided
 24 recommendations for management consideration.
 25 I'll just make this one comment, and again,

Page 24

1 this is not directly related to our work, but
 2 in that second sentence where it says,
 3 Deloitte's report was scathe -- scathing to its
 4 findings, I suppose that's subject to the
 5 reader's interpretations, but I believe the
 6 report states the facts and reported on the
 7 facts. We didn't, you know, issue an opinion
 8 one way or the other in any type of objective
 9 form. So, you know, again, you know, subject
 10 to the readers determining if the facts are
 11 scathing, then so be it. Part of the way down
 12 that first paragraph where it mentions, you
 13 know, the Commission performed no due diligence
 14 and had no controls, again, I also think that's
 15 somewhat of an inaccurate statement insofar as
 16 it suggests that there was a complete absence
 17 of these types of activities and controls, and
 18 that is not the case. While I would say that
 19 there -- you know, it may have varied in degree
 20 or, you know, as a work in progress. But to
 21 say that there was no due diligence or no
 22 controls I think is not an accurate depiction
 23 of the current environment that we looked at.
 24 So certain things, you know, I would say that
 25 was a work in progress, such as the development

Page 25

1 of the ongoing due diligence procedures, the
 2 mobilization of the initial to -- while there
 3 may have been activities taking place not
 4 following a consistent program or not
 5 consistently applied, to say that there was no
 6 activity would not be accurate. Continuing on
 7 onto page 8, there's about three quarters of
 8 the way down on that first paragraph where it
 9 says, you know, according to, in 2011 Deloitte
 10 found financial statement risk to be high and
 11 remained high in 2012, the scope of the work we
 12 did in 2012 did not look at anything related to
 13 or directly related to the financial statement
 14 risk. So again, coming back, we focused on the
 15 due diligence program. So I don't know that we
 16 can extrapolate that statement based on the
 17 work that we did in 2012. And then lastly on
 18 page 9, on page 9, point 3 -- point 3, where it
 19 says, you know, in connection with our work in
 20 2011, the accounting capabilities, wasn't
 21 entirely certain, you know, what capabilities
 22 meant. When we did our work in 2011, we
 23 focused on the processes and the tools that the
 24 Investment Commission had related to the
 25 financial statement process. You know, we

Page 26

1 certainly did not get into the responsibilities
 2 or the capabilities of the individuals
 3 responsible for performing any of these tasks.
 4 So I don't think that we can make, you know,
 5 make that statement. And then last point 4,
 6 again, you know, projected term I think
 7 extremely weak. I don't believe our report
 8 makes any type of value judgment such as that.
 9 We just simply did not -- we simply reported on
 10 the facts. And so those are my initial
 11 thoughts on the letter, and I'd be happy to
 12 answer any specific questions.
 13 **THE CHAIRMAN:** Yeah, if we could, you know, you
 14 mentioned at the bottom of page 6, you know,
 15 the three areas we wound up looking at of the
 16 numerous that were listed. As I recall the
 17 initial proposal if we were to cover them all
 18 was going to be budget, and you may recall
 19 better than I do since you're the one who made
 20 the bid, was in the 750 to \$800,00 range; is
 21 that correct?
 22 **MR. CHUNG:** That is correct.
 23 **THE CHAIRMAN:** And we would up going with three on a
 24 smaller budget, as well as we discussed that
 25 we'd be hiring internal people, which y'all

Page 27

1 were going to help us with with the idea that
 2 they would come back in and follow up on the
 3 other open items, as I recall.
 4 **MR. CHUNG:** Yes, that is correct as well.
 5 **THE CHAIRMAN:** Okay. We've already talked -- I'll
 6 ask you the same question we asked earlier,
 7 whether just as a practice we should provide a
 8 management rep letter, even though management
 9 as defined or as we heard Clifton Gunderson's
 10 position -- I guess it's Clifton Gunderson and
 11 Larson, is that the corporate name?
 12 **MS. CORBETT:** Clifton Larson Allen.
 13 **THE CHAIRMAN:** Allen, man, they sound like a law
 14 firm now. Whether we should just as practice
 15 develop a management rep letter procedure that
 16 would go to the Retirement System. Do you have
 17 a thought on that, Michael?
 18 **MR. CHUNG:** Well, I think any time that you
 19 implement, you know, any additional controls to
 20 help create efficiencies and make the overall
 21 control environment more effective is a good
 22 thing. The only word of caution would be that,
 23 you know, that there's some rigor behind it and
 24 that both sides, whether it's the Retirement
 25 System or the Investment Commission or any

Page 28

1 other party understands the processes that
 2 underlie the management rep letter and that
 3 it's not just a perfunctory exercise so that
 4 everyone who's going to rely on it will have
 5 some idea as to what went into making those
 6 representations.
 7 **THE CHAIRMAN:** Next on the question of sort of the
 8 high risk environment, particularly the high
 9 risk concerning financial statements, I guess,
 10 you know, one of the questions under what
 11 circumstances would that, for a plan our size
 12 would that not, you know, I guess is it
 13 possible that that would ever, regardless of
 14 the procedures be deemed not to be a high risk
 15 area, even under normal operations?
 16 **MR. CHUNG:** Well, I think, you know, we sort of look
 17 at this in part. So if you're looking at just
 18 the inherent risk, then I would say that
 19 financial statements would always be, there's
 20 always high inherent risk to the financial
 21 statement process. Then depending on the
 22 controls activities that are baked into the
 23 process then I think you can mitigate some of
 24 those inherent risk so that what you're left
 25 with is you're looking at the residual risks as

Page 29

1 to, you know, are there controls, are there,
 2 you know, are the controls designed
 3 effectively, are they operating effectively,
 4 things of that nature, and then you can
 5 certainly mitigate those risks. But on the one
 6 level I would say that inherently it is a high
 7 risk area, and then depending on, you know, the
 8 resources, the tools, the reporting, all of
 9 that that may be put into the process you can
 10 mitigate some of those risks.
 11 **THE CHAIRMAN:** And this is kind of a follow up. I
 12 know we looked at the cross trading area,
 13 right, and one of the questions in there was
 14 the that that we had no controls over cross
 15 trading. Cross trading obviously is an allowed
 16 activity by investment management firms, they
 17 have to have procedures around it which the SEC
 18 would require. What would be the expectations
 19 and, you know, I guess a lot of this type of
 20 activity goes on, you know, frequently without
 21 client knowledge, right. Obviously we're aware
 22 that this type of activity exists. Have you
 23 worked with staff or is that something you've
 24 communicated, what would be the expectation of
 25 what sort of internal controls we should have

Page 30

1 other than just awareness on cross trading
 2 activities? I mean obviously --
 3 **MR. CHUNG:** Yes.
 4 **THE CHAIRMAN:** -- our partnerships vary, right, so
 5 you know, in different circumstances we'd
 6 probably have different degrees of control as
 7 relates to cross trading activities. But can
 8 you maybe address that a little?
 9 **MR. CHUNG:** Certainly. And here I think it's
 10 important to distinguish who the primary actors
 11 are versus the secondary actors. In this
 12 particular instance given the Commissions what
 13 I'm going to say investment model where it uses
 14 external managers for the investment activity,
 15 those underlying external investment managers
 16 for the strategic partnerships, as the case may
 17 be, are the primary actors. And by that I mean
 18 that they are the entities responsible for
 19 determining when a particular transaction,
 20 whether it's a cross trade or just a straight
 21 up buy/sale position is being performed. The
 22 Investment Commission is a secondary actor
 23 insofar as it does not control that initial
 24 decision, but the Commission has the ultimate
 25 responsibility for overseeing the plan assets.

Page 31

1 So what the Commission needs to do to help
 2 mitigate some of this process, that's why it
 3 ties back into that due diligence. Because it
 4 is not the primary actor making that initial
 5 decision it should have some sort of mechanism,
 6 a program in place to understand the
 7 circumstances under which these activites takes
 8 place, whether it's just a straight up buy/sale
 9 or a cross trade or any other aspects of the
 10 investment process that the Commission is not
 11 primarily responsible. So that's why it was
 12 included as part of looking at the overall due
 13 diligence program.
 14 **MR. CHERNICK:** Just one quick note. I know the
 15 investment team incorporated reviewing cross
 16 trade and trade allocation policy in the new
 17 initial due diligence procedures that were
 18 presented at the last Commission meeting, so.
 19 And have been adopted and are currently in
 20 place for a presentation that will happen next
 21 week, so.
 22 **THE CHAIRMAN:** Now, in this kind of, I guess, open
 23 question because, again, we have different
 24 degrees of control depending on, you know, our
 25 different structures. Have we identified the

Page 32

1 different where we have more controls versus
 2 less controls where --
 3 **MR. CHERNICK:** Specifically related to cross trades
 4 or --
 5 **THE CHAIRMAN:** Yeah. Yeah.
 6 **MR. CHERNICK:** No, I mean, that's on the to do list.
 7 **THE CHAIRMAN:** Right.
 8 **MR. CHERNICK:** I mean we figured the best processes
 9 is to implement it, get it up and running
 10 immediately so all new investments it will be
 11 something we're fully aware of, but it's
 12 something that we look to consult on, you know,
 13 in the near future. So we have time built into
 14 our audit plan which Monica will be presenting
 15 for consulting projects and this is a scenario
 16 where, you know, me and Monica's background
 17 will help, you know, add some value to the
 18 investment team in how to tackle this control
 19 concern.
 20 **THE CHAIRMAN:** Sort of another area that the letter
 21 kind of asked about has to do with valuations,
 22 and similar question to, you know, my question
 23 related to the cross tradings, what are the
 24 expected controls over processes of external
 25 managers, right? I mean the letter

Page 33

1 specifically seems to imply an expectation of
 2 testing.
 3 MR. CHERNICK: I'm going to be doing a presentation
 4 which, you know, sort of addresses the
 5 Chairman's question about what processes we're
 6 implementing, you know, how we're improving our
 7 processes. It doesn't specifically address
 8 your question, but I can speak to some of the
 9 accounting guidance, but obviously Mr. Rey and
 10 Mr. Chung would have expertise in this area
 11 too. So this will be covered in the area.
 12 MR. CHAIRMAN: Would either of you on the phone like
 13 to, are you able to kind of answer that? What
 14 are the expected controls over processes
 15 related to valuation of external managers which
 16 we would be expected to have?
 17 MR. CHUNG: I can take a first pass at this, and
 18 again, I think it's similar to the cross
 19 trading, you know, I think you want to look at
 20 this from who are the primary actors and who
 21 are the secondary actors. You know, again here
 22 the underlying managers, they would be the
 23 primary actor insofar as they make that initial
 24 valuation type determination. From the
 25 Commission's perspective, and I think the

Page 34

1 guidance is laid out fairly well in the letter
 2 regarding the expectations, but you know, part
 3 of the overall due diligence process is to have
 4 a mechanism in there to understand, you know,
 5 the investment strategies of the underlying
 6 managers, the types of instruments that they
 7 are using to implement those strategies, but
 8 more importantly as is noted that, you know,
 9 the assumptions that go into these valuation
 10 determinations. And I know we started off this
 11 conversation as to, you know, who may -- who
 12 may be the, you know, management or the party
 13 ultimately responsible for ensuring that the
 14 information that gets input into financial
 15 statements is correct or accurate. And here,
 16 you know, from the Commission's perspective we
 17 have, you know, essentially three different
 18 parties in play here, the underlying managers,
 19 the Investment Commission that's responsible
 20 for overseeing the investments, and the
 21 Retirement System that's responsible for
 22 preparing the financial statement. So it's a
 23 coordinated effort across all three of these
 24 areas, you know, overseeing what the external
 25 managers are doing, understanding the

Page 35

1 information being provided and having some
 2 rigor built into that process to break it apart
 3 and say okay, here's how the information is
 4 put together, here's the assumptions, all of
 5 that, and then, you know, coordinating or
 6 communicating with the Retirement System, you
 7 know, to pass that information along and then
 8 connecting all the dots in between.
 9 MR. CHERNICK: Mr. Rey, quick question. You know,
 10 regardless of whether the controls were in
 11 place or were sufficient in your firm's manner,
 12 could you guys still gain comfort on the
 13 valuations to be able to issue an unqualified
 14 audit opinion?
 15 MR. REY: Yes. I mean, that's another inaccuracy in
 16 the letter as well, in my opinion. As I said,
 17 and Michael did a good job of pointing out, I
 18 did not see in the Deloitte report nor did we
 19 see any evidence where there's no due
 20 diligence. So certainly due diligence,
 21 Michael's made a great, you know, made some
 22 good points in terms of the importance of due
 23 diligence. When I read the report certain I
 24 think everyone at the Commission and staff,
 25 etcetera, would agree that enhancements need to

Page 36

1 be made. So while that is a part of the
 2 Retirement Systems, and we talk about the
 3 communication between the Investment Commission
 4 and the Retirement Systems, certainly the
 5 Investment Commission is part, and their
 6 operations are part of the control environment
 7 around financial reporting at South Carolina
 8 Retirement Systems. We walked through and just
 9 as in accordance with standards, we do -- we
 10 consider the internal control environment, we
 11 do walk-throughs of those -- of the due
 12 diligence that's going on, and then we
 13 determine again via risk assessment where there
 14 is high risk, then we would use more
 15 substantive features. So again, we tested both
 16 on existence and valuation approximately 90
 17 percent of those non-custodial assets. As
 18 well, there are compensating controls for some
 19 of the limited controls at the Commission,
 20 there are compensating controls as well that
 21 are going on at the Retirement System. Again,
 22 the Retirement System either via communications
 23 with the Commission or on a mailing list
 24 themselves get audited financial statements
 25 directly sent to the Retirement System. So

Page 37

1 they're doing, they're enhancing or doing
 2 additional due diligence procedures while they
 3 can't -- while they don't have direct access to
 4 the managers, they're certainly not doing the
 5 up front due diligence, are not part of that
 6 process, in the hiring decision, there is all
 7 those -- there is ongoing due diligence in
 8 terms of valuation and you can see -- they're
 9 all audited by big, you know, highly qualified
 10 firms, Deloitte being one of them, in terms of
 11 some of the partnerships, strategic
 12 partnerships etcetera. And when you read those
 13 financial statements you get a feel for what
 14 are those underlying assets. Particularly even
 15 in the strategic partnerships many of those
 16 strategic partnerships are structured where
 17 they're really a fund to funds where they're
 18 invested in other funds of that particular
 19 manager, and in many cases those funds are
 20 invested in highly liquid, you know, level one
 21 type securities and then put in the financial
 22 statement, audited financial statements of the
 23 strategic partnerships, for instance, they
 24 might be listed as level two simply because
 25 they're funds. So circling back to your

Page 38

1 initial question, we assess, we do a risk
 2 assessment, we consider internal controls , and
 3 where there aren't internal controls that can
 4 be relied upon to the degree where we can
 5 reduce testing, we actually would increase
 6 testing, and that's exactly what we did.
 7 MR. CHERNICK: And quick question, Mr. Rey. I think
 8 you audit a wide variety of pension plans. I
 9 assume do you see different scopes of controls
 10 or different levels of controls across the
 11 board between all those retirement systems that
 12 you're a part of auditing?
 13 MR. REY: Yes. I mean I wish that everyone was
 14 perfect, but they're not. We do similar
 15 engagements to Deloitte and very rarely do we
 16 not have recommendations for enhancement or
 17 alignment with best practices in regards to due
 18 diligence.
 19 THE CHAIRMAN: And question I'm not quite sure who
 20 to direct to, maybe to Reynolds and to you Mr.
 21 Rey You mentioned sort of the control
 22 environment how it has to flow across multiple
 23 parties from the manager to us that has direct
 24 interaction with the manager over to the
 25 Retirement System. Are there any things that

Page 39

1 contractually inhibit our ability to share
 2 information across the environment and across
 3 agencies? I know this is one of the issues
 4 that, you know, came up as it related to
 5 confidentiality and going to other parties.
 6 But are there any things that would block
 7 information from getting, you know, to an
 8 agency that has another responsibility of which
 9 we're --
 10 MR. WILLIAMS: I don't know that I'm the right one
 11 to answer that question because the only
 12 contracts that I've ever read are the ones that
 13 I've signed.
 14 THE CHAIRMAN: Right.
 15 MR. WILLIAMS: So there have been four years worth
 16 that are outside my bailiwick. But I'll defer
 17 to Nancy or Robert on that.
 18 MR. FEINSTEIN: Allen, are you referring to in this
 19 case is the function or task the responsibility
 20 relating to preparation of the annual financial
 21 statement?
 22 THE CHAIRMAN: It is, right, because we have
 23 different degrees of control like in these
 24 partnerships, right? Obviously they have --
 25 Mr. Rey mentioned 2010, 2011, some reluctance,

Page 40

1 right? And I don't know what that was, right.
 2 I mean, we didn't have an Audit Committee and
 3 such at that point in time. But what I want to
 4 make sure is that there aren't any things that
 5 would inhibit the flow of information that
 6 would be needed on the other side for them to
 7 perform their function appropriately.
 8 MR. WILLIAMS: I have read the MOU from October 2011
 9 that y'all did last year to solve these issues,
 10 and that doesn't have anything in it that would
 11 prohibit the free flow of information.
 12 MR. FEINSTEIN: Right. No, if anything I think that
 13 really clarifies --
 14 MR. WILLIAMS: And I think that sort of waived --
 15 MR. FEINSTEIN: Yeah.
 16 MR. WILLIAMS: -- all the potential defects in the
 17 free flow of information, if there were any.
 18 MR. FEINSTEIN: I think it identifies -- for
 19 purposes of this particular function, I think
 20 your presenters have correctly identified the
 21 key parties; it's the Commission, the external
 22 auditor, SCRS of course ultimately, and then to
 23 some degree managers. And I think we through
 24 the MOU and other steps that have been taken,
 25 I think there are no barriers to any of those

Page 41

1 actors getting the information, sharing the
 2 information that they need in order to complete
 3 the annual financial statement audit.
 4 MR. REY: And this is just my personal opinion, that
 5 the communication flow has improved some
 6 exponentially from those -- from our initial
 7 request for information to today. So I mean I
 8 don't -- we're not aware of any current
 9 barriers and there's been a free flow of
 10 information between the Commission and
 11 Retirement System.
 12 MS. HOUSTON: Mr. Rey, this is Monica Houston. One
 13 of my things I'm understanding in terms of the
 14 procedures you performed is that you did
 15 something that is I think a little bit unique
 16 to the industry in that you did, I think, 100
 17 percent population when you looked at
 18 valuations. Can you speak to that.
 19 MR. REY: No. I didn't do 100 percent. I mean I
 20 think I talked, and I don't know that I talked
 21 percentages, but --
 22 MR. CHAIRMAN: You said 90.
 23 MR. REY: -- what we do, and Mike, I've been on
 24 previous calls and, you know, Deloitte even as
 25 part of their risk assessment, and what happens

Page 42

1 here is, you know, I think everyone at the
 2 table is aware and that's why the alternative
 3 investments, even if we -- if we subscribed to
 4 every best practice in terms of due diligence
 5 would still be a high risk area in terms of
 6 valuation. All the non-custodial assets are
 7 not really subject -- I mean, the money has
 8 been -- he commitments have been made directly,
 9 they're not held, you know, they're not held in
 10 custody of Bank of New York, they're actually
 11 held directly by the partners, the general
 12 partners and invested in accordance with those
 13 varying strategies. And so what we did was we
 14 carved out, we basically -- you can confirm
 15 valuation of the custodial assets, the
 16 equities, the -- you know, the actual stocks
 17 and bonds that are market to market daily, that
 18 confirmation can come whether directly with the
 19 manager, but more typically with -- directly
 20 with the custodial bank, so in this case, Bank
 21 of New York. What we do is we carve -- the
 22 entire portfolio is shown on the Bank of New
 23 York statement; however, that's really a
 24 customer courtesy so when you get your monthly
 25 statement you see all of the assets of the

Page 43

1 portfolio. So we identify all of those non-
 2 custodial assets, carve those out, and you do
 3 point out that that's perhaps unique, I don't
 4 know that it should be, but we take that entire
 5 population of non-custodial assets, which are
 6 primarily the alternative assets and we audit
 7 -- we audit them separately for existence and
 8 valuation. And in this case simply because
 9 there was no reliance placed -- if I were to
 10 rely on, if there was a strong system of
 11 internal controls starting even at, you know,
 12 there are multiple players, but starting at the
 13 Investment Commission, and had I, you know,
 14 based on previous testing, we've tested
 15 internal controls and we would perhaps --
 16 standards would allow us to even reduce testing
 17 in some cases. But we don't rely on the
 18 internal controls at the Investment Commission.
 19 For one we're not auditing the Investment
 20 Commission. We're not in a position to be able
 21 to even do what Deloitte did and do a full risk
 22 assessment of the Investment Commission. So
 23 we're not going to opine on the internal
 24 controls of the Investment Commission. We
 25 just consider that as a part of the overall

Page 44

1 control environment of SCRS. And in that
 2 consideration then we determine how much
 3 testing, because it's a high risk area, how
 4 much testing we're going to do for existence
 5 and valuation. And in this case this year we
 6 set a materiality threshold of a certain dollar
 7 limit, and we looked at every position or every
 8 investment that exceeded that. And if you took
 9 that population we tested 90 -- well 89.4
 10 percent of the non-custodial dollars for both
 11 existence and valuation. And so there are
 12 there -- there certainly is AICPA guidance in
 13 terms of internal controls and man -- and the
 14 investee, how they go about doing those
 15 valuations. So I think the Treasurer's letter
 16 and perhaps -- perhaps somewhat misguided
 17 because if you take it and you read it and
 18 you're like, hey, management is -- management
 19 should be doing their own valuations. That's
 20 impractical and virtually impossible to take
 21 and have anyone, even at the Investment
 22 Commission to do a separate standalone
 23 valuation that then rivals the valuation or the
 24 NAV that comes out of the general partner. So
 25 again, we sent independent confirmations to all

Page 45

1 those managers in terms of existence. They
 2 send us back their valuations as of June 30,
 3 and they send us their audited financial
 4 statements as of, in many -- in most cases
 5 they're all audited and the year ends of those
 6 particular funds are December 31st. And then
 7 we perform roll forward procedures from those
 8 audited NAV numbers to the NAVs that are
 9 recorded in the financial statements as of
 10 June 30, and we did that for 90 percent of the
 11 portfolio. Of the alternative or non-custodial
 12 portfolio.
 13 MR. WILLIAMS: Have you found that the valuation
 14 methodology described in the contracts is
 15 sufficiently clear that you can -- you could
 16 duplicate their work if you had the resources
 17 and tried to do it, or is it vague?
 18 MR. REY: Well, again, there is -- I mean the
 19 standards, you have the fair value standards
 20 that were issued, and then the AICPA
 21 subsequently, and I think, you know, rightfully
 22 so continue to make clarifications. And one of
 23 their last clarifications was a good one, and
 24 I think it applies in terms of long-term
 25 investments and how to value and how to accept

Page 46

1 net asset value. So certainly there's a
 2 reliance on the fact that these funds are being
 3 audited and those auditors are testing the
 4 underlying securities. What we are doing is
 5 we're testing the reasonableness of the net
 6 asset value of a limited partnership interest.
 7 And so you're looking at those financial
 8 statements, you're looking at those contracts.
 9 There is a reliance on, you know, on those
 10 auditors in terms of they're looking at the
 11 internal controls, you know, and the back
 12 office, and the valuation and due diligence
 13 that the general partners are doing. So not in
 14 -- so there's -- Michael mentioned the general
 15 partners, but they're a key player as well to
 16 where what are the controls in place at the
 17 general partner, what are their valuation
 18 policies and procedures, what are their back
 19 office issues. And so those other audit firms
 20 are auditing those, taking those internal
 21 controls of the general partner and then
 22 they're auditing the underlying assets of these
 23 various funds, and then they're ultimately
 24 issuing financial statements that are in
 25 accordance with GAAP and are in accordance with

Page 47

1 prevailing fair value standards. And those are
 2 the things that we're looking or in terms of
 3 okay, I have an NAV, it's been audited by
 4 another firm and it's been audited in
 5 accordance with GAAP and I -- fair, you know,
 6 US fair value and/or IFRS fair value standards.
 7 THE CHAIRMAN: Kind of a question, and I know it
 8 always will depend on the particulars of the
 9 case, but you mentioned the importance of the
 10 GP and it's one of the things that's kind of
 11 alluded to in the letter. At one point would,
 12 you know, a value sort of restatement, right,
 13 obviously you get interim valuations, you get
 14 final valuations. But at what point would you
 15 go from sort of ordinary course of business in,
 16 you know, valuation restatements or tightening
 17 up under different circumstances into a
 18 potential fraud case?
 19 MR. REY: I'm just not following that question.
 20 THE CHAIRMAN: At what point does say, you know, if
 21 there were a manager, right, and you know,
 22 subsequent valuation testing or something and
 23 you had a large restatement, right --
 24 MR. WILLIAMS: What are the red flags?
 25 THE CHAIRMAN: What are the red flags essentially

Page 48

1 that might allude you to, you know, it's a
 2 material, you know, restatement, but at what
 3 point does it go from material into, you know,
 4 should raise a red flag as a potential
 5 fraudulent situation?
 6 MR. CHUNG: This is Mike Chung. I can take a first
 7 pass at this and then I'll hand it back over to
 8 Mr. Rey. I think just because you have a
 9 restatement, you know, large or small, isn't by
 10 itself an indication of, you know, some
 11 fraudulent activity. I think that's why it's
 12 important to have some type of rigorous ongoing
 13 monitoring process or due diligence so that if
 14 you detect a pattern of activity, you know,
 15 there's a trend or, you know, it seems like if
 16 there's repeatable offense occurring, you know,
 17 at the end of the month or something, you know,
 18 that may be suggestive of fraudulent activity.
 19 But you can't draw a conclusion based on one
 20 isolated event. And that's why say, you know,
 21 I think your particular circumstance is
 22 somewhat unique in that you have three
 23 different parties, you know, looking at the
 24 totality of that process front to back to say,
 25 you know, here are the high risk areas and

Page 49

1 that's where you want to focus your control
 2 activities to say we need to now guard against
 3 that and be iden -- well, I shouldn't say
 4 identify, to maybe see if there are any
 5 potential red flags that would, you know, give
 6 you an indication that, you know, if a control
 7 breakdown were to happen, this is where it's
 8 most likely.
 9 MR. REY: And I would echo that as well. Again, the
 10 financial statements and any restatements that
 11 might occur are just one of -- if you look at
 12 the best practice or a due diligence checklist,
 13 which by the way again continues to change, as
 14 these investment strategies change, I mean a
 15 hedge fund, every hedge fund is different, so
 16 I mean even to have a hedge fund due diligence
 17 checklist might not necessarily be all
 18 encompassing for that particular strategy. But
 19 again, what you're doing, and kind of going
 20 back and this is just one layer of, you know,
 21 you're peeling back the onion, and one layer of
 22 internal control would be hey, I have the
 23 unaudited manager valuation as of 12/31, and
 24 every year for some reason the auditors come in
 25 and make, you know, large adjustments to the

Page 50

1 valuation. So that's just one step of many in
 2 your due diligence process to say, you know,
 3 hey, is the audit process at the general
 4 partner, is part of the audit practice there,
 5 you know, routinely there are, you know,
 6 significant audit adjustments, that would then
 7 be a red flag for perhaps the internal control
 8 and the evaluation process at the general
 9 partner, one of many red flags that could
 10 potentially pop up in a rigorous due diligence
 11 process. Or even who the auditor is, I mean
 12 hindsight is 20/20, but if anyone had done due
 13 diligence on Bernard Madoff and you looked at
 14 who his auditor, who his audit firm was and the
 15 fact that he hit his benchmark every year, you
 16 know, it's obviously -- those are all red flags
 17 in hindsight.
 18 THE CHAIRMAN: Right. Can I ask you a question on
 19 that, and this is just more kind of inquiry,
 20 but as it relates just to big firms. Do y'all
 21 report which offices does it? I know like in
 22 the Arthur Andersen case all the audits came
 23 out of the Houston office. Do y'all actually
 24 report down to office level?
 25 MR. CHUNG: Could you repeat that question?

Page 51

1 THE CHAIRMAN: Yeah. Like meaning do y'all put
 2 which, like you'd see Deloitte on a lot of GP
 3 valuations, right, but do y'all actually list
 4 which Deloitte office does that? Because I
 5 know in the case of like Arthur Andersen,
 6 right, most of their problems related back to
 7 their Houston office practice, not the rest of
 8 firm, right. But do y'all actually show sort
 9 of which office, practice office handles when
 10 y'all, you know, are doing reports for GP or
 11 something like that?
 12 MR. CHUNG: On Deloitte's side, I am not aware of
 13 any practice where we indicate that this was
 14 done out of the New York office. We sign as a
 15 firm. And for that matter, the team that's
 16 doing the audit could be composed of staff,
 17 management, managers from multiple locations.
 18 So we are, you know, geographic and not --
 19 MR. FEINSTEIN: All the former Deloitte people are
 20 nodding.
 21 MS. HOUSTON: Well, EY, it's the same for EY, for
 22 PWC, for KPMG, it's the same practice, even --
 23 you know, for even regional firms.
 24 THE CHAIRMAN: You have anything?
 25 MR. WILLIAMS: Yeah. Michael, we got Mr. Rey's

Page 52

1 answer to this question, but let me get your
 2 reaction to it. I'm referring to page 11 of
 3 the letter, the first paragraph under
 4 conclusion and request. Is there anything in
 5 your risk assessment report that would
 6 reasonably give concern so serious that it
 7 would question the ability to complete the
 8 audit as scheduled?
 9 MR. CHUNG: Are you talking about the financial
 10 statement audit?
 11 MR. WILLIAMS: Yeah.
 12 MR. CHUNG: Well, you know we, as part of our work
 13 we do not look at anything that Clifton, or
 14 activities that were taking place on the
 15 Retirement System side. So I have absolutely
 16 no facts to state one way or the other.
 17 MR. WILLIAMS: And the concerns you did have and you
 18 expressed to us in your risk assessment report,
 19 are we addressing them?
 20 MR. CHUNG: Yes. I mean, I can certainly say that,
 21 you know, based on, you know, where we ended at
 22 the end of page 1, you know, as we work, you
 23 know, the time we spent on site, you know,
 24 during phase two to its conclusion, I can point
 25 to certain specific things that show that, you

Page 53

1 know, progress is being made and has been made.
 2 But again as Andrew mentioned, a lot of this is
 3 a work in progress and, you know, continued
 4 efforts, you know, to proceed forward. If I
 5 could just add one comment, everything that Mr.
 6 Rey had described as part of this process,
 7 again this is, without doing any type of formal
 8 testing I think sounds -- sounds very
 9 consistent with what -- you know, what I have
 10 come to learn as standard industry practices.
 11 MR. WILLIAMS: Okay. That's all I had. Thanks,
 12 Mike.
 13 THE CHAIRMAN: Any other questions?
 14 MR. WILLIAMS: No.
 15 THE CHAIRMAN: All right. I believe we're -- thank
 16 you both for your participation. I don't
 17 believe there are any more questions. You're
 18 obviously free to stay on or free to go about
 19 your day, but we do appreciate you making
 20 yourselves available.
 21 MR. WILLIAMS: I do have one other thing. Michael,
 22 are you going to be available to come to the
 23 Commission meeting next week?
 24 MR. CHUNG: I won't be able to attend in person, but
 25 I'll be dialing in again.

Page 54

1 MR. WILLIAMS: Okay. Thanks.
 2 MR. REY: Thank you.
 3 MR. CHUNG: Andrew, do you want me to stay on for
 4 this next piece or am I good to drop?
 5 MR. CHERNICK: Michael, it's totally up to you.
 6 MR. WILLIAMS: You're welcome to stay but if you
 7 have more interesting things to do, that would
 8 not be surprising.
 9 MR. CHUNG: Well, I'll stay on for a bit and see if
 10 there's any other questions that Andrew may
 11 want to ask or anyone else.
 12 MR. CHERNICK: Sounds good.
 13 THE CHAIRMAN: I would like to make one motion as a
 14 result of that conversation, right, but I'd
 15 have to relinquish --
 16 MR. WILLIAMS: We have a two member committee --
 17 THE CHAIRMAN: We have two members so I've got to --
 18 MR. WILLIAMS: -- make a statement.
 19 THE CHAIRMAN: Well, I've got to relinquish the
 20 chair --
 21 MR. WILLIAMS: No, don't do that.
 22 THE CHAIRMAN: -- to make the motion, right?
 23 MR. WILLIAMS: Say what it is and we can just -- we
 24 can just agree on it.
 25 THE CHAIRMAN: Well, just on the management

Page 55

1 representation, I do think we ought to
 2 formalize that procedure and develop some sort
 3 of management representation letter that could
 4 be provided to the Retirement System.
 5 MR. FEINSTEIN: To SCRS?
 6 THE CHAIRMAN: SCRS.
 7 MR. WILLIAMS: I'm not quite sure what a management
 8 letter is since I've never done one, read one.
 9 Sounds like it's probably a good idea so I'll
 10 defer to your wisdom on that.
 11 MR. CHERNICK: And just to clarify, the rep letter
 12 is addressed to Clifton Larson or is it
 13 addressed to Retirement System?
 14 MS. CORBETT: How we're working on it right now is
 15 addressing it to the Retirement Systems.
 16 MR. CHERNICK: Okay.
 17 MS. CORBETT: But we do have a draft of that letter
 18 that we are working on with staff and as soon
 19 as we, you know, get that where we're happy
 20 with it, we'll be glad to share it with y'all
 21 for review and with the Retirement Systems as
 22 well, of course.
 23 MOTION:
 24 THE CHAIRMAN: I'd like to make that as a motion so
 25 we can make it as a recommendation next week.

Page 56

1 MR. WILLIAMS: And we'll make it to the --
 2 THE CHAIRMAN: Full Commission.
 3 MR. WILLIAMS: No, the management letter, we'll --
 4 THE CHAIRMAN: Yeah, we would make it to PEBA.
 5 MR. WILLIAMS: Okay.
 6 THE CHAIRMAN: Right.
 7 MR. WILLIAMS: Yeah. Yeah, go ahead, that's duly
 8 resolved.
 9 THE CHAIRMAN: Second?
 10 MR. WILLIAMS: Second and vote for.
 11 THE CHAIRMAN: All in favor?
 12 MR. WILLIAMS: Yeah.
 13 THE CHAIRMAN: All right. So we'll make that as a
 14 formal recommendation to the full Commission
 15 next week.
 16 APPROVAL OF 2012-13 AUDIT AND COMPLIANCE PLAN:
 17 THE CHAIRMAN: Next item on the agenda alternative
 18 investment valuation procedures. I'll turn it
 19 over to Mr. Chernick for that.
 20 MR. CHERNICK: Just obviously a very topical
 21 conversation and just make note, we were
 22 working on this presentation approving the
 23 processes before the Treasurer's letter, but
 24 you know, now it's obviously very timely as
 25 it's a hot topic. So we were going to cover it