

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

**February 10, 2015**

**Capitol Center  
1201 Main Street, 15<sup>th</sup> 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 Tuesday, February 10, 2015:** Betsy Burn, Gail Cassar, Andrew Chernick, Dori Ditty, Lorelei Graye, John Farmer, Rebecca Gunnlaugsson (via phone), Monica Houston, Mike Hitchcock, James Manning, and Jon Rychner from the South Carolina Retirement System Investment Commission (“RSIC”); Melinda Al-Hasan from the State Treasurer’s Office; Tammy Nichols and John Page from the Public Employee Benefits Authority; Wayne Pruitt, Roger Smith, 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 3:00 p.m. The agenda was unanimously approved.
- II. Approval of Minutes:** The minutes of the meetings of September 18, 2014, November 6, 2014, December 10, 2014, December 18, 2014, and January 6, 2015 were approved without objection.
- III. Audit Committee Follow-up:** Ms. Monica Houston, Chief Audit Officer, reported on new items including approval of old minutes and possible scheduling of an Investment and Operational Due Diligence presentation to the Audit Committee in May. The Audit Committee self-evaluation was performed and is closed. The discussion on the Audit Committee obtaining outside legal counsel is closed. The presentation of the Code of Ethics to the Commission for approval is closed.
- IV. Human Resources Update – ERM and Compliance Position:** Mr. John Farmer, Human Resources Director reviewed the search for ERM and Compliance Director

position and confirmed that Mr. Eric Nelson had been hired and started on February 2, 2015. Chairman Gillespie provided a brief introduction of and welcome to Mr. Nelson.

- V. ERM and Compliance Update and Transition:** Mr. Andrew Chernick, Managing Director Operations and Operational Due Diligence reported that he has maintained focus on continuing the momentum on compliance measures already implemented and that he has delayed on ERM implementation to allow for creative flexibility of the new ERM and Compliance Director. He said that he will continue to do compliance checks for the upcoming Commission meeting. Mr. Nelson reported that his initial approach will be reviewing governance and policy, the latter of which he believes may have gaps. He will look to start development of Risk management mid-March/April, he will look at Funston deadlines and Audit Committee Charter requirements to develop a plan. Ms. Boykin noted that he will make a presentation to the PEBA board on risk management.
- VI. Review of Audit Committee Charter:** Chairman Gillespie reviewed the summary results of annual AC Charter compliance review. He noted that most of the areas of non-compliance were related to the ERM function and provided commentary on the reasoning for such as well as confirmed that action plans were in place for addressing the concern. Ms. Boykin asked how the Committee will receive reporting on the accomplishment of the development of a comprehensive risk management program. Chairman Gillespie noted that it is up to the Audit Committee to declare what it wants to see and that he and Mr. Nelson have discussed meeting with the key personnel and Board members to determine reporting requirements. Ms. Boykin further inquired about the timeframe on a scope. Mr. Nelson noted that the scalability of the enterprise risk management program would be a challenge. He stated that he intends to create a compliance template for approval within a couple of months and expects it to be a reiterative process. He will prioritize risk management reporting based upon key areas that appear to have higher residual risk and expects to have a mock report for that activity by September. Chairman Gillespie expressed concern that although an RFP had gone out and been awarded on a system designed to generate reporting over a year ago Commissioners who rely on some level of reporting had not been engaged (by management) in the Conifer implementation. Mr. Chernick noted that a presentation on Conifer is forth coming at the April Commission meeting. Mr. Giobbe asked if Mr. Nelson saw any risk management overlap between the investment side and the administrative side. Mr. Nelson noted that RSIC's risk analytics group appeared to be fairly robust and that it will not be valuable to review risk management tools but instead to review processes for consistency.
- VII. Internal Audit Update:** Ms. Houston discussed the updated audit plan and noted that she had a favorable meeting with Mr. Chernick on the budget. The Management Fees

and Expenses audits for 2013 and 2014 were combined and are completed. She noted that internal audit is in the process of contracting with Clifton, Larson Allen (CLA) to perform agreed upon procedures for Investment Valuation, Investment Due Diligence and Operational Due Diligence. The State Auditor expanded upon the procedures to be performed to include work normally performed by them on RSIC's administrative functions and compliance with the State Comptroller policies. Mr. Gillespie inquired as to any potential conflict of interest with the external auditor performing internal audit work. Ms. Houston stated that such a concern had been discussed and that as a part of the contracting process the State Auditor will obtain a conflict of interest attestation letter from CLA; CLA reviewed the concern internally and have indicated they have no conflict. Ms. Houston noted that Elliot Davis will be brought in for the IT audit as per the rotation in the Service Provider policy. Mr. Chernick confirmed that about 80 hours remain for the completion of the Contract Compliance – SP review. Ms. Houston made further note that the audit on Investment Approval and Funding is on hold due to current legislative concerns that management is monitoring. Other internal audit items have no changes aside from the extension of some dates due to the expanded timing for the Management Fees and Expenses audit as a result of a deeper than projected look into management fees. Based upon an inquiry by Mr. Giobbe, discussion was had relative to the review of Incentive Compensation. Mr. Michael Hitchcock indicated that the organization was in the midst of an RFP for Compensation Consultant and hopes to have a deliverable by April/May on what the full spectrum of compensation for the organization should look like. Chairman Gillespie noted that the Audit Committee's purview related to incentive compensation centered on whether any perverse incentives were being created and whether it was calculated correctly and that the question at hand was more appropriate for the full board. Ms. Houston noted that in the most recent audit of Incentive Compensation, management's response to recommendations relative to compensation plan revisions was that they were awaiting the results of the compensation review. Chairman Gillespie inquired relative to the budget and the need for any changes to the scope based upon such. Mr. Hitchcock indicated that there was not. Ms. Houston requested approval of the updated plan as presented. Prior to Committee calling for a vote, Ms. Houston steered the Committee's attention to the Service Delivery report contained in the IA Update noting that 64% of the work is in audit, 3% in compliance, 21% in consulting and the rest in other management requests and internal projects. Ms. Boykin asked if the audit of Investment Contract Management will begin in June, and Ms. Houston replied that it was a consulting engagement and should be completed in June. Ms. Houston discussed potential modification to the scope of the Entity Level Controls as a result of work Mr. Nelson was planning to perform to prevent overlap. Mr. Giobbe moved to approve the updated audit plan which was approved unanimously.

**VIII. Management Fees and Expenses:** Ms. Houston begin by providing a detailed explanation audit relative to the bifurcation of the 2013 and 2014 reviews. Ms. Houston reviewed the objectives and scope of the audit. Mr. Gillespie noted that management fees has become a hot button for the SEC and recently there have been articles relative to Private Equity firms making rebates. He inquired on the applicability of the rebate issue to Observation #2. Mr. Chernick noted that this refers to the lack of an internal reporting process for a fee term change and that it will be addressed. Mr. Gillespie asked if RSIC is aware of the fees to the portfolio firm, the subject highlighted in the SEC probe. Mr. Chernick and Ms. Lorelei Graye noted that RSIC is asking more questions pertinent to this. Mr. Gillespie asked if the manager survey speaks to this issue, and Mr. Chernick replied that it does. Mr. Giobbe asked if given the complexity of the process indicated on page 3 of the report that RSIC will be able to provide reasonable assurance that there is an accurate accounting of non-invoiced fees. Mr. Chernick answered in the affirmative making reference to the additional work RSIC performs in this area and invited Ms. Graye to join the discussion. Mr. Giobbe further inquired relative to the ability to obtain information from managers to which Ms. Graye replied that RSIC experienced a high level of manager compliance for fee information requests. Further discussion centered on the process and level of detail obtained in the fee validation process with Ms. Tammy Nichols and Ms. Gail Cassar providing input. Ms. Houston noted validation of the non-invoiced fees is being transitioned to Conifer. Mr. Giobbe asked about reporting of fees at other public funds; Mr. Chernick and Ms. Houston indicated that most report only what is required but that the netting of the fees to determine FMV was standard amongst all plans. Ms. Houston reviewed the Summary of Control Strengths making note that the process was evolving and that it was very much improved. She further noted that management has implemented previous Internal Audit recommendations on this issue. Ms. Houston continued to present the remainder of the report walking through the observation risk rating process. Mr. Gillespie inquired relative to the use of spreadsheets and controls over the transmission of information between RSIC and the investment managers. Ms. Graye indicated that they are transmitted securely from the managers. Ms. Houston stated that there were no material misstatements of the fee balance or significant areas of internal weakness noted. Five observations were presented in the report. Mr. Gillespie asked for additional clarity relative to Observation #5 to which a discussion was held with Mr. Chernick and Ms. Houston providing input. Mr. Hitchcock stated that management must better document policies and procedures to track compliance. He added that repeatability is the goal. Mr. Gillespie further inquired about documentation for the purposes of record keeping and the level of integration of Tamale. A discussion ensued wherein Mr. Chernick and Ms. Graye noted that Tamale has been that repository and Conifer will be in the future and Ms. Houston noted that the utilization and reliance of Tamale does not extend beyond it as a repository.

- IX. Review from PEBA External Auditor:** Thomas Rey, Partner, Clifton Larson Allen (CLA) joined the meeting via phone, and Ms. Gunnlaugsson also confirmed her presence on the phone. Chairman Gillespie requested that Mr. Rey report to the Committee on the most recent external audit, the agreed upon procedures engagement, and if needed the management representation letter. Mr. Rey reported that the PEBA SCRS financial statement audit received an unmodified opinion, previously referred to as an unqualified opinion and noted that a big part of the audit is the assistance of RSIC in the area of valuation. Mr. Rey said the audit went well and thanked RSIC for its cooperation. Ms. Houston provided commentary relative to what was previously discussed in the meeting and requested Mr. Rey provide information relative to CLA's approval of the agreed upon procedures. Mr. Rey discussed the challenges incurred in the process particularly those relative to obtaining procedures with the required amount of specificity from the State Auditor. He noted that CLA is very close to agreement with the State Auditor on the agreed upon procedures and expected to provide an engagement letter in a couple of weeks.
- X. Discussion of Management Representation Letter:** Mr. Gillespie inquired about the history of the Management Representation Letter. Mr. Rey provided the historical nature of the letter as per his perspective and recollection. He noted that the letter was designed a few years ago to give PEBA comfort as to the completeness and accuracy of information provided by RSIC particularly the fair value of the assets. He stated that the letter is not "absolutely mandatory" but "important" to the audit process. It also reflects a very good relationship between PEBA and RSIC. Mr. Gillespie shared his concern as to the circumstances that occurred in the provision of the letter raising the question of timeliness and inquired of Mr. Rey as to the proper protocol for provision of the letter. Mr. Rey noted that the proper protocol probably is that PEBA request and then RSIC furnish the letter. Ms. Boykin confirmed the importance and usefulness of the letter to PEBA and indicated that PEBA has modified its procedures to ensure timely provision of the letter from RSIC. Mr. Gillespie expressed concern that the letter was exactly the same from year to year and inquired as to its adequacy. Mr. Chernick noted that RSIC tailored the traditional form to fit RSIC as it was believed that as an inter-company management letter much of the items were not applicable or required. Mr. Gillespie countered that although many of the areas are not applicable, there are several related to off balance sheet derivative usage and investment structures that should be addressed in a management letter. Mr. Hitchcock indicated that the protocol and contents will be reviewed and presented to the Audit Committee going forward. Mr. Rey validated the concern expressed by Mr. Gillespie and stated that providing representation on the details of the under portfolio and offered that a addressing controls specific to the portfolio in addition to the valuation would provide a more robust letter that would be beneficial to PEBA. Mr. Gillespie indicated that the action item would be that someone from RSIC participate in the management

representation meeting with PEBA the next time. Ms. Boykin stated that PEBA will meet with RSIC going forward to discuss the timing and contents of the letter.

**XI. Executive Session:** The committee unanimously voted to enter executive session at 4:36 pm to discuss personnel matters and receive legal advice. No actions were taken

**XII. Adjournment:** Chairman Gillespie adjourned the meeting at 5:54 pm.

[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 15<sup>th</sup> Floor Conference Room at 1201 Main Street, Columbia, SC, at 3:40 p.m. on February 6, 2015.]