

September 26, 2006

The Honorable Edward G. Rendell
GOVERNOR
Commonwealth of Pennsylvania
225 Main Capitol Building
Harrisburg, Pennsylvania 17120

The Honorable Nicholas J. Maiale
CHAIRMAN
Commonwealth of Pennsylvania
State Employees Retirement System
30 North Third Street, Suite 150
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Gentlemen:

This report contains the results of the Department of the Auditor General's special performance audit of the investment operations of the State Employees' Retirement System (SERS). The audit covered the period January 1, 2001 through December 31, 2004, and was conducted in accordance with *Government Auditing Standards* as issued by the Comptroller General of the United States.

The report includes projections that reveal the potential for a fiscal crisis at SERS in 2012 or 2013. According to information provided by SERS, the contributions from employers—that is, taxpayers—may need to increase five to eight-fold in order to meet future retirement obligations.

The objectives of this engagement were to:

- Evaluate the organizational structure and resources of SERS to determine if it is effectively accomplishing its mission;
- Review the legal provisions that govern SERS' investment operations and determine if there are instances in which the provisions may restrict SERS' independence or hamper its ability to achieve its mission;
- Determine if SERS' policies and procedures intended to act as guidelines in selecting and monitoring investment advisory consultants are adequate and functioning as designed and if the contractual obligations of investment advisory consultants are being met;

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- Determine if SERS' policies and procedures intended to act as guidelines in selecting and monitoring investment managers are adequate and functioning as designed and if the contractual obligations, if any, of managers are being met;
- Determine if adequate procedures have been implemented to respond to and recover funds lost as a result of past corporate financial reporting improprieties; and
- Evaluate the extent to which SERS has made an effort to invest in and contract with Pennsylvania firms.

The report is divided into six chapters, each containing findings and recommendations relative to the above objectives.

In Chapter One, we make recommendations that can improve how SERS ensures that potential conflicts of interest are adequately monitored and disclosed by individual board members with the assistance of the SERS Board Secretary and SERS' consultants and managers. In addition, we recommend that the training provided to board members be formalized, including the establishment of a method to track the number of training programs attended by each board member, and that certain improvements be made to the structure of the internal audit operation.

Chapter Two contains recommendations that urge SERS' management to continue to work with the Governor's Office of Administration, Office of the Budget, and Office of General Counsel in a manner that takes full advantage of the resources that these offices provide. At the same time, SERS' legal office should continue to be cognizant of any potential conflicts of interest that might exist and be prepared to assist SERS to obtain independent counsel when necessary. This chapter also includes a recommendation to ensure that all SERS documents appropriately reflect the SERS legal office's determination that SERS' board members are subject to the "prudent investor" standard. The final recommendation in this chapter calls for SERS to seek a legislative change to the prudence standard outlined in the SERS Retirement Code to ensure that it encompasses all of the key elements of the "Prudent Investor Rule" contained in the Pennsylvania Probate, Estates and Fiduciaries Code as specifically tailored to investments made by a public pension system; alternately, or in the meantime, SERS should amend its investment policy accordingly.

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In Chapters Three and Four, we compliment management regarding how efficiently it selects and monitors investment advisors and managers. However, we recommend that improvements be made in documenting certain disclosures in contracts with investment advisory consultants.

Chapter Five discusses how SERS' management should formally adopt securities litigation policies and procedures and that the securities litigation deliberations be better documented. Finally, in Chapter Six, we encourage the board to continue to make a concerted effort to invest in and with Pennsylvania firms.

As explained in the "Objectives, Scope and Methodology" section of our report, Appendix B contains a report from Independent Fiduciary Services, Inc. (IFS) on its fiduciary review of SERS with regard to many of these same issues. IFS is also issuing a separate report on other issues regarding SERS' investment operations.

It is important to note that the fund appears to be managed by a staff of qualified professionals who are committed to maximizing return on investments while at the same time protecting the interests of the members. However, SERS faces considerable challenges in the years to come. It is of critical importance that the work begin with the General Assembly and the SERS Board to take the necessary steps to avoid any future fiscal crisis. It is my hope that the implementation of the 18 recommendations made in this report will be a good first step towards averting this crisis.

Sincerely,

JACK WAGNER
Auditor General

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Executive Summary

The Department of the Auditor General, through its Bureau of Special Performance Audits, conducted this performance audit in order to provide an independent assessment of the investment operations of the Pennsylvania State Employees' Retirement System (SERS). We conducted our work in accordance with *Generally Accepted Government Auditing Standards* as issued by the Comptroller General of the United States. The audit period for this performance audit consisted of the four years beginning January 1, 2001, and ending December 31, 2004. Fieldwork began on April 25, 2005 and continued through May 1, 2006. Our 15 findings and their corresponding recommendations are listed below:

Finding 1.1 – SERS' Board Policies Regarding Conflicts Of Interest Require Improvement To Ensure That The Policies Properly Reflect The Fiduciary Duties Of Board Members Of A Public Pension Plan Like SERS.

Recommendations: We recommend that, to assist the individual Board members in their self-monitoring and reporting efforts, the Board should address the issue of conflicts of interest by issuing guidelines for Board members and their designees that exceed those in the Ethics Act, the applicable codes of conduct, and SERS' Bylaws. At a minimum, the Board should:

- Define a conflict of interest as it specifically pertains to a Board member's fiduciary duty, including establishing a minimum campaign contribution amount that would trigger action by the Board member and indicating under what circumstances a Board member should publicly disclose a potential conflict, abstain from voting, and disclose on the record the nature of the potential conflict;
- Require the Board's Secretary to obtain copies of all campaign finance reports that the Board members who are elected public officials are required to file with the Department of State, so that the Board Secretary can assist Board members in identifying specific instances in which a member's vote would violate the conflict of interest policy; and

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- Require all investment advisory consultants and investment managers to provide an up-to-date comprehensive disclosure statement of all campaign contributions made by principals or employees of their investment firms to Board members within the past ten years to the Board Secretary each time that the consultant or manager makes a presentation before the Board, so that the Board Secretary can assist Board members in complying with the conflict of interest policy.

Finding 1.2 – SERS Did Not Maintain A Formal Training Program For Its Board Members Or Sufficiently Track The Number Of Training Programs Attended By Each Board Member.

Recommendations: We recommend that SERS' staff develop, with the Board's approval, a formal Board member training program, including objectives and guidelines for new and existing Board members to include minimum annual training requirements. The training program should include basic investment classes for new members and gradually add intermediate classes and advanced sessions. Additionally, SERS should continue with in-house educational presentations, including a review of the prudence standard to which the Board members must adhere, while at the same time maintaining educational training records for each Board member.

Finding 1.3 - SERS' Internal Audit Office Lacked Organizational Independence.

Recommendations: We recommend that:

- SERS realign its current organizational structure so that the Internal Audit Office reports to both the Executive Director and the Board's Audit Committee. Additionally, the Internal Auditor should periodically update SERS' Board and senior management on the Internal Audit Office's purpose, authority, responsibilities, and performance relative to its audit plan. Such a status update should include an overview of the status of significant risk exposures and control issues, governance issues, and other matters needed or requested by the Board and senior management.
- As part of this organizational realignment, the Board's Audit Committee should assume the responsibility for:

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- Assuring and maintaining, through the organizational structure of the organization and by other means, the independence of the internal audit process;
 - Ensuring that there are no unjustified restrictions or limitations placed on the internal audit staff;
 - Reviewing with management and the Internal Auditor the charter, objectives, plans, activities, staffing, budget, qualifications, and organizational structure of the internal audit function; and
 - Reviewing the effectiveness of the internal audit function, including compliance with the Institute of Internal Auditors' (IIA) most recent standards.
- Finally, to strengthen the position of the Internal Audit Office, its charter should be presented to the SERS Board for approval, consistent with IIA's Standard 1000.

Finding 2.1 – Although SERS Is Subject To Oversight By The Governor's Office Of Administration (OA), OA Appears To Hamper Neither SERS' Independence To Make Investments Nor Its Mission.

Recommendation: We recommend that SERS make more of a concerted effort to work closely with OA in order to ensure that the impact of any administrative limitations is diminished. For example, SERS could select a staff member who would act as an OA liaison charged with regularly updating the SERS staff, the SERS Board, and OA on any problems that SERS may be experiencing with administrative issues and hold regularly scheduled monthly or quarterly meetings with OA to work through issues on an ongoing basis.

Finding 2.2 – The Governor's Office Of General Counsel (OGC) On The Whole Appears To Present No Impediments That Hamper SERS' Independence To Make Investments Or Its Mission.

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Recommendations: We recommend the following:

- SERS' staff, particularly its legal staff, should make more of a concerted effort to work closely with OGC in order to help diminish any delays and unnecessary burdens that may arise as the result of OGC policies and procedures. One example of how to accomplish such increased cooperation includes the possibility of seeking an agreement with the Governor's General Counsel to provide SERS' Chief Counsel with more latitude to make certain types of decisions without the need for approval on a case-by-case basis.
- In the alternative, if SERS determines that it is problematic to have OGC provide it with legal services, SERS should, with appropriate written justification, seek approval from the General Counsel to grant SERS' current Chief Counsel and his assistants complete independence from OGC, or SERS could seek authorization from the General Counsel to hire a chief counsel and various assistants, perhaps through a memorandum of understanding.

Finding 2.3 - SERS Has Not Been Consistent With Regard To Identifying The Prudence Standard To Which It Has Determined The Board Is Subject.

Recommendations: We recommend the following:

- SERS should ensure that all of its documents consistently refer to the "prudent investor standard," which is the prudence standard to which SERS' Chief Counsel has determined the SERS Board members are subject.
- All SERS' Board members **and** their designees should be provided with an immediate orientation session, a member orientation packet, and an additional training program about the prudence standard to which they are subject and what it means both in terms of their obligations and their accountability to SERS' members if they do not meet their obligations.

Finding 2.4 – It Is Unclear Whether The Prudence Language In The SERS Retirement Code, Which Was Adopted In 1974, Is Adequate To Reflect The Prudent Investor Rule Contained In The Uniform Prudent Investor Act As Adopted In 1994 And Amended Into The Pennsylvania Probate Code In 1999.

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Recommendations: Because SERS and the SERS Board have made the determination that they are subject to the “prudent investor” standard, they should seek a legislative change to the provision in the SERS Retirement Code containing the Board members’ prudence standard to ensure that it encompasses all of the key elements of the Prudent Investor Rule contained in the Pennsylvania Probate Code as specifically tailored to investments made by the fiduciary board of a public pension plan. Alternately, or in the meantime, they should amend SERS’ investment policy accordingly.

The General Assembly should, independent of SERS, consider amending the SERS Retirement Code to reflect the Prudent Investor Rule contained in the Pennsylvania Probate Code as specifically tailored to investments made by the fiduciary board of a public pension plan.

Finding 3.1 – SERS’ Procurement Processes For Investment Advisory Consultants Worked As Intended And The Investment Consultants And Actuary Complied With Their Contracts.

Recommendation: No recommendation is necessary.

Finding 3.2 - SERS Adequately Monitored The Relationships Between Its Three Investment Advisory Consultants And Its External Investment Managers; However, SERS Did Not Require Annual Disclosure Documentation In Its Contracts With The Consultants.

Recommendation: We recommend that SERS amend the contracts with all three investment consultants to include annual disclosure documentation as a contractual requirement and include such a requirement in future contracts.

Finding 4.1 – SERS’ Due Diligence Process For Selecting Investment Managers Was Adequate And Appropriately Documented.

Recommendation: No recommendation is necessary.

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Finding 4.2 – SERS Implemented Sufficient Policies And Procedures To Adequately Monitor Investment Managers' Performance And To Ensure Compliance With Contract Provisions.

Recommendation: No recommendation is necessary.

Finding 5.1 – SERS' Board Did Not Formally Adopt Securities Litigation Policies And Procedures.

Recommendation: We recommend that SERS' Board formally adopt, by Board resolution, its "Proposed Steps in Securities Litigation Process," dated April 7, 2004.

Subsequent Event: SERS implemented this recommendation by having the SERS Board formally adopt the "Proposed Steps in Securities Litigation Process" at its May 2006 meeting.

Finding 5.2 – SERS' Staff Properly Monitored Securities Litigation Claims.

Recommendation: No recommendation is necessary.

Finding 5.3 - The Securities Litigation Committee Did Not Document Its Meetings And Only Twice During The Audit Period Were Notations Made In The Board's Meeting Minutes That Securities Litigation Activity Was Discussed.

Recommendation: The Securities Litigation Committee should document its meetings in written form.

Finding 6.1 – SERS Made A Conscientious Effort To Make Investments In Pennsylvania And Reported These Investments To The General Assembly.

Recommendation: SERS' Board should continue to make a conscientious effort to invest in Pennsylvania projects and businesses consistent with the requirements of law and its fiduciary duty to SERS' members.

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Introduction and Background

*"While a private retirement plan can be the creation of an individual, the public plan is [by force of circumstances] the product of legislative enactment and often of compromise."*¹

---Thomas P. Bleakney

This report by the Department of the Auditor General (Department) presents the results of a performance audit of the investment operations of the State Employees' Retirement System (SERS), a defined benefit public pension plan, for the period January 1, 2001, through December 31, 2004. This performance audit was conducted by the Department's Bureau of Special Performance Audits. Fieldwork was conducted from April 25, 2005, through May 1, 2006. A defined benefit plan is a retirement program under which the employer guarantees a level of retirement benefits, as determined by formula, to employees who are members of the plan and meet certain eligibility requirements.

Overview of SERS

SERS was established by Act 331 of 1923 to provide benefits to employees of the Commonwealth of Pennsylvania. SERS is a governmental employer defined benefit pension plan and is considered a component unit of the Commonwealth of Pennsylvania's executive budget. SERS' operations are governed by the State Employees' Retirement Code (Retirement Code).² Other state and federal statutes also impact SERS operations.

SERS' Mission Statement reads:

The mission of SERS is to provide retirement benefits and services to our members through sound administration and prudent investments.³

The State Employees' Retirement Board (Board) was established by law as an independent administrative board,⁴ and exercises control and management of the State Employees Retirement System (System), including the investment of its assets.⁵

¹ Thomas P. Bleakney, *Retirement Systems for Public Employees*, Richard D. Irwin, Homewood, Illinois, 1972, pp. 8-9.

² See 71 Pa.C.S. § 5101 *et seq.*

³ SERS' 2005 Comprehensive Annual Financial Report, December 31, 2005, p. vii.

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Public employees eligible to participate in the SERS' plan, which is funded through employee and employer contributions and returns on investments, include all full-time public and part-time employees of the Commonwealth who work at least 100 days or 750 hours of service yearly. As of December 31, 2005, the plan had approximately 110,000 state employees who were members of SERS.⁶

The chart in Figure 1 tracks the funded ratio of SERS' asset values to its actuarially determined liabilities. We note that the funded ratio has gone down in recent years, from a high of 116.3% in 2001 to 92.9% in 2005.⁷

⁴ 71 Pa.C.S. § 5901(a).

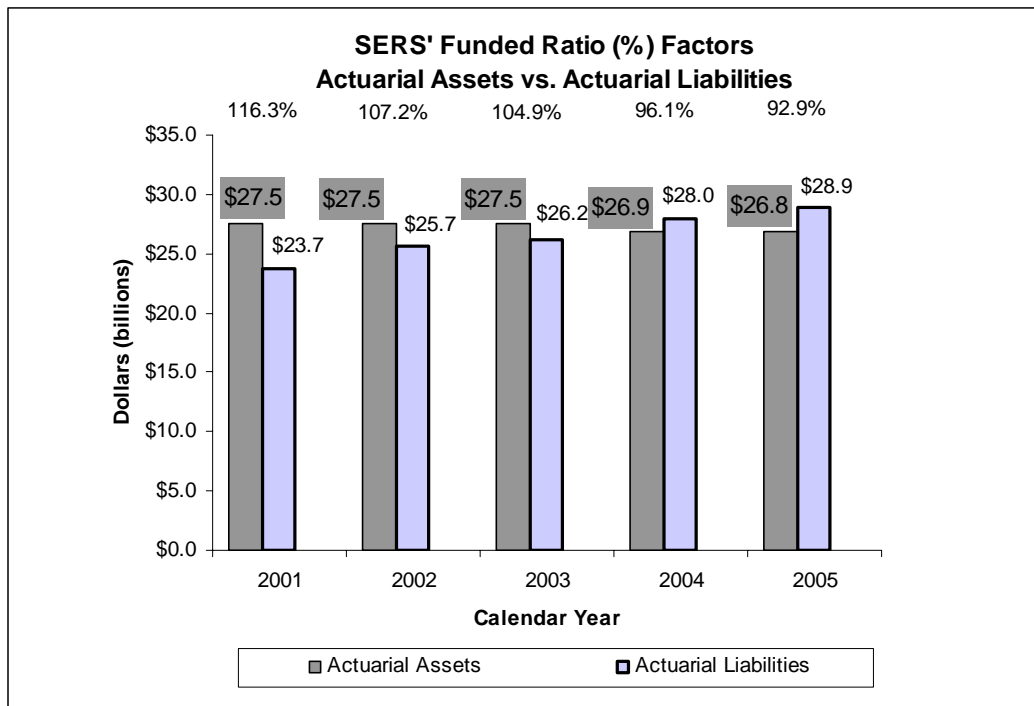
⁵ 71 Pa.C.S. § 5931(a).

⁶ SERS' 2005 Actuarial Report, Hay Group, April 26, 2006, p. 1.

⁷ The funded ratio measures the ratio of net actuarial assets against actuarially determined liabilities and is one indicator of the fiscal strength of a pension fund's ability to meet obligations to its members.

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Figure 1 - SERS' Funded Ratios⁸



⁸ Data compiled from SERS' actuary reports.

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The following table reflects projections of retirees and active employees through the year 2015 made by SERS' actuary:

Table 1. Annuitants and Employees⁹

Calendar Year	Total Retiree and Survivor Lives	Active Employees
2006	102,968	109,981
2007	104,968	109,981
2008	107,481	109,981
2009	109,648	109,981
2010	111,719	109,981
2011	113,670	109,981
2012	115,368	109,981
2013	116,802	109,981
2014	117,976	109,981
2015	118,910	109,981

SERS has received numerous awards and has made significant achievements in the public pension fund arena. For example:

- In 2005, SERS' Chief Investment Officer received the Institutional Investor Award for Excellence in Investment Management.¹⁰
- In 2005, SERS received the 2004 Large Public Pension Plan of the Year award at the annual Public Plans Summit in Phoenix, Arizona. This national

⁹ SERS' 2005 Actuarial Report, Hay Group, April 26, 2006, p. 25. Note that the active employee projection remains frozen; however, the retirement projections reflect greater numbers anticipated because of future medical program changes that will occur under the current collective bargaining agreement.

¹⁰ The award, granted by *Institutional Investor Magazine*, honors the outstanding achievements of the executives who manage U.S. pension plans, endowments, and foundations.

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honor, awarded by *Money Management Letter*, recognized SERS for outstanding investment returns and member services.¹¹

- Each of SERS' Comprehensive Annual Financial Reports for the period 2001 through 2004 received an annual Certificate of Achievement for Excellence in Financial Reporting.¹²

The Importance of Investment Performance

Increasing volatility introduced by fiscal stress in state government budgets coupled with low investment returns in the early part of this decade and a desire to increase benefits have required public pension systems to become ever more aggressive in managing their investments. Indeed, investment performance is paramount for SERS as it strives to exceed the rate of return assumed by SERS' actuaries. This audit of the investment operations of SERS is vital to ensure that the System is operating as efficiently and effectively as possible.

Another factor that came to our attention during the course of our audit that makes it all the more important to highlight the investment performance of SERS at this time is that employers whose employees and retirees are covered by the SERS plan (including all of the agencies under the Governor's jurisdiction, as well as the legislative and judicial branches of state government), will be confronted with a dramatically increased employer contribution rate within the next five to six years, climbing to as high as 23% in 2013. In Table 2, SERS has projected that employer contributions will increase six-to-eight fold by 2012 and 2013, respectively.¹³

¹¹ *Money Management Letter*, which is targeted for the use of money managers, consultants, and professional staff of public pension plans, provides information on U.S. defined benefit pension funds relating to subjects such as legislation, marketing strategies, consulting, and executive appointments.

¹² The Certificate of Achievement, awarded by the Government Finance Officers Association of the United States and Canada, is a prestigious national award, recognizing conformance with the highest standards for preparation of state and local government financial reports.

¹³ SERS 2005 Budget Documents transmitted to the General Assembly, "Funding Process and Actuarial Status," February 18, 2005, p. 7.

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Calendar Year	Employer Contributions (Dollars in Millions)
2006	181
2007	265
2008	291
2009	252
2010	252
2011	370
2012	986
2013	1,492
2014	1,459
2015	1,596

The projections in Table 2 came about as the result of the convergence of several circumstances that can be summarized as follows:

- Legislation was enacted in 2001¹⁵ and 2002¹⁶ to increase employee retirement benefits at a time when economic conditions appeared favorable enough to allow for such increases without any negative consequences.
- A significant downturn in the economy beginning in late 2001 and continuing until the end of 2003 impacted the investment markets and, in turn, led to investment losses for SERS.¹⁷

¹⁴ SERS' 2004 Actuarial Report, Schedule K.

¹⁵ Act 9 of 2001 provided for the following with regard to SERS: 1) a reduction of the employee vesting period from 10 years to 5 years; 2) an increase in retirement benefits for active members, who elected to participate in the new class, by 25 percent; and 3) the creation of two new classes with contribution rates increasing for most members who elected a new class and those hired after June 30, 2001 from 5.00% to 6.25%.

¹⁶ Act 38 of 2002 provided for the following: 1) a two-part cost-of-living increase for annuitants; 2) a minimum employer contribution rate equal to no less than one percent of employee payroll; and 3) the establishment at five years the period over which all realized and unrealized gains and losses will be recognized in determining actuarial asset value.

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- Following SERS' investment losses, employer contributions to SERS were reduced or suspended based on the application of a formula contained in law that took into account the successful investment performance of the funds over the prior decade.¹⁸
 - When it became apparent that this would result in an immediate and significant gap in fund liabilities to available assets, legislation¹⁹ was enacted to allow the amortization period for certain liabilities to be changed in order to permit the employer costs to be deferred for ten years, but not avoided, and to establish a percentage floor of annual employer contribution rates until 2007.²⁰

SERS (like the Public School Employees' Retirement System (PSERS)) has been proactive in attempting to ensure that the projected employer contribution increases, their associated effects, and possible remedies are fully examined and brought to the attention of key public officials who may be able to assist in seeking meaningful solutions to the issues that these projected increases raise.²¹ For example, on September 1, 2005, SERS

¹⁷ September 1, 2005 joint letter from the Executive Directors of PSERS and SERS to Michael J. Masch, Secretary of the Budget, p. 1.

¹⁸ See Act 38 of 2002.

¹⁹ Act 40 of 2003 provided as follows: 1) beginning July 1, 2004, increased the minimum employer contribution rate from 1 percent to 4 percent to be phased-in over time through 2007 but not continuing thereafter; 2) increased from 10 years to 30 years the amortization of accrued liability costs associated with Act 9 changes, and the losses incurred in fiscal year (FY) 2000-01 and FY 2001-02; and 3) continued the ten-year amortization of unfunded liabilities from Act 38, from legislation enacted before Act 9, and from future benefit changes and cost of living increases.

²⁰ Based on a SERS memorandum dated March 15, 2006 regarding its funding, the employer "balloon payments" beginning in 2012 are the intentional result of Act 40 of 2003, which changed the SERS amortization schedule to "hold down rates now at the expense of higher rates later." According to information provided in the SERS 2006 Supplemental Budget Information, "In essence, Act 2003-40 refinanced the pension mortgage from a 10-year term to a 30-year term. The Act also set a series of floor contribution rates....[Furthermore,] Act 2003-40 changed the amortization schedule in a way that was intended to reduce employer contributions over a 10-year period by approximately \$5 billion, while maintaining the employer rate in single digits through 2011."

²¹ Although the employer contribution rate issue was not part of our audit scope and objectives and we did not conduct an actuarial analyses of the status of SERS' pension fund, it is important to take this opportunity to assist SERS (and PSERS) in its efforts to shed a spotlight on this issue so that policymakers may take appropriate action to help achieve the stability of SERS' (and PSERS') pension plan. Please note that the Pennsylvania courts have consistently held that the benefits of existing public pension plan members cannot be diminished or adversely affected even if the changes are necessary to bolster the

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and PSERS wrote the Secretary of the Budget a comprehensive letter providing him with an update about the funding status of both systems and suggesting possible funding alternatives. The letter states in part, "Consistent with the Systems' fiduciary obligation to our members and our duty to Commonwealth taxpayers to operate in a fiscally prudent manner, the Systems have been exploring and are prepared to discuss with you, options for dealing with the pending increases in our respective employer contribution rates."²² The letter also explains that, although Act 40 of 2003 has helped to suppress some of the immediate large employer contribution increases forecasted for both systems, it "merely postpones" significant increases in the contribution rate until fiscal year 2012-13.²³ We urge the Boards, the Governor, and the General Assembly to work together to address this critical issue that will soon impact the SERS and PSERS retirement plans.

actuarial soundness of the fund. (See, e.g., *Association of Pa. State College and University Facilities v. State System of Higher Education*, 505 Pa. 369, 479 A.2d 962 (1984)).

²² September 1, 2005 joint letter from the Executive Directors of PSERS and SERS to Michael J. Masch, Secretary of the Budget, p. 2.

²³ *Ibid.*, pp. 2-3.

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Objectives, Scope, and Methodology

The Department of the Auditor General, through its Bureau of Special Performance Audits, conducted this performance audit in order to provide an independent assessment of the investment operations of the Pennsylvania State Employees' Retirement System. We conducted our work in accordance with *Generally Accepted Government Auditing Standards* as issued by the Comptroller General of the United States. The audit period for this performance audit consisted of the four years beginning January 1, 2001, and ending December 31, 2004. Fieldwork began on April 25, 2005 and continued through May 1, 2006.

Our audit objectives consisted of the following:

- To evaluate the organizational structure and resources of SERS to determine if it is effectively accomplishing its mission.
- To review the legal provisions that govern SERS' investment operations and determine if there are instances in which the provisions may restrict SERS' independence or hamper its ability to achieve its mission.
- To determine if SERS' policies and procedures intended to act as guidelines in selecting and monitoring investment advisory consultants are adequate and functioning as designed and if the contractual obligations of investment advisory consultants are being met.
- To determine if SERS' policies and procedures intended to act as guidelines in selecting and monitoring investment managers are adequate and functioning as designed and if the contractual obligations, if any, of managers are being met.
- To determine if adequate procedures have been implemented to respond to and recover funds lost as a result of past corporate financial reporting improprieties.

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- To evaluate the extent to which SERS has made an effort to invest in and contract with Pennsylvania firms.

The audit methodology that we employed for this engagement included conducting interviews; reviewing contracts, reports, and accounting records; reviewing policies and procedures; reviewing laws and regulations; and conducting a survey of other pension systems. Each chapter includes specific details regarding the individual methodology performed and the audit steps completed for particular objectives.

In April 2005, the Department of the Auditor General, SERS, and PSERS entered into a contract with Independent Fiduciary Services, Inc. (IFS) of Washington DC, for IFS to conduct a comprehensive “fiduciary review” of the investment operations of the systems and to provide support for certain aspects of our performance audits of SERS and PSERS. IFS is a nationally recognized consulting firm with experience examining the operations of the large public pension plans. In general, the Department’s performance audit examined whether each system complied with certain policies and procedures, while IFS’ fiduciary review compared the system’s policies and procedures with “best practices” at leading funds in other states. Both organizations sought to identify areas in which the systems’ policies and procedures could be improved.

Because the objectives for each task were broad and the basic focus of our work differs in that IFS performed a fiduciary review, as opposed to a performance audit, the aspects of SERS’ operations and activities that we chose to audit and the methodologies that we employed, in many cases, differed from IFS. Therefore, it is important to note the similarities and the differences in the approaches taken and in the results obtained, if any, for the fiduciary review completed by IFS for each task area. We have included specific details regarding these similarities and differences within each chapter of our report.

Pursuant to the contract, IFS has prepared two reports for each system. IFS’ report in support of the Department’s audit objectives for SERS, which includes comments from both SERS and the Department, is attached as Appendix B. In addition, IFS prepared a separate report on the following issues: investment policy, asset allocation, investment performance, investment performance reporting, performance benchmarks, costs and fees, investment personnel practices, investment manager structure, trust and custody arrangements, fiduciary liability insurance, innovative practices, proxy voting processes, and disaster preparedness. That separate report also includes comments from both SERS and the Department.

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Chapter One Organizational Structure and Resources

The State Employees' Retirement System was established in 1923 and is one of the nation's oldest and largest statewide retirement plans for public employees. As of December 31, 2005, it had more than 211,000 members, of which approximately 110,000 were state employees and 101,000 were retirees.²⁴

The SERS Board (Board) is comprised of 11 members who stand in a fiduciary relationship to the SERS plan members regarding the investments and disbursements of the SERS fund (Fund) monies.²⁵ It is an "independent administrative board"²⁶ which is ultimately responsible for the oversight of the operations of the System. The Board receives assistance in fulfilling its responsibilities from SERS' staff, consultants, and investment managers.

The members of the SERS Board, as trustees of the Fund,²⁷ have exclusive control and management over the Fund, and the full power to invest the Fund, subject to meeting the prudence standard to which they are subject under Section 5931(a) of the Retirement Code.²⁸ The Board also performs other functions as are required for the administration of the System.

A critical foundation for any organization is a strong organizational structure promoting, among other things, efficient organizational communication, appropriate oversight of operations, and an adequate understanding of roles within the organization. Accordingly, we reviewed SERS' organizational structure to determine whether it has all of the essential elements for a well-functioning state public pension plan whose Board

²⁴ SERS' 2005 Actuarial Report, Hay Group, April 26, 2006, p. 1.

²⁵ 71 Pa.C.S. § 5931(e). The Retirement Code does not contain a definition of the term "Fund." However, Section 5932 of the Retirement Code, 71 Pa.C.S. § 5932, provides as follows: "The fund shall consist of all balances in the several separate accounts set apart to be used under the direction of the board for the benefit of members of the system; and the Treasury Department shall credit to the fund all moneys received from the Department of Revenue arising from the contributions required under the provisions of Chapter 55 (relating to contributions), and any income earned by the investments or moneys of said fund."

²⁶ 71 Pa.C.S. § 5901(a).

²⁷ Section 5931(a) of the Retirement Code, 71 Pa.C.S. § 5931(a), provides, in pertinent part, as follows: "The members of the board shall be the trustees of the fund."

²⁸ 71 Pa.C.S. § 5931(a). See a further discussion of this issue in Findings 2.3 and 2.4 in Chapter 2 of this report.

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members have a fiduciary duty to invest and manage SERS Fund monies for the exclusive benefit of its members.

Objectives and Methodology

Our objective was to evaluate the organizational structure and resources of SERS to determine if it is effectively accomplishing its mission. In order to meet this objective, the primary focus of our testing was to verify that the Board is fulfilling its responsibilities under the Retirement Code, verify that investment-related Board committees are functioning as intended, and verify that SERS has an independent internal audit group that reviews internal controls.

Accordingly, we performed the following major steps:

- Reviewed the Retirement Code and applicable regulations;
- Reviewed SERS' mission statement, written policies and procedures, and other documentation pertaining to SERS' day-to-day operations;
- Reviewed SERS' Comprehensive Annual Financial Reports and budgetary reports for years ended December 31, 2001, 2002, 2003, 2004, and 2005;
- Reviewed all 33 SERS' Board meeting minutes for the audit period and observed seven Board meetings held during audit fieldwork to ensure that Board processes and procedures are conducted in accordance with governing policies;
- Reviewed all 366 Board resolutions passed during the audit period to verify that they were presented and voted upon in accordance with Board policies and procedures;
- Obtained career and educational information on all 11 individual Board members to evaluate their backgrounds in investment and finance;
- Reviewed documentation of Board member training to determine its appropriateness and sufficiency;

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- Evaluated how the Board and individual Board members dealt with potential conflicts of interest under the Public Official and Employee Ethics Act (Ethics Act);²⁹
 - Interviewed all 11 SERS Board members;
 - Reviewed the Internal Auditor's continuing professional education (CPE) records to determine if the Internal Auditor met the CPE requirements necessary to maintain licensure as a certified public accountant;
 - Reviewed the Internal Auditor's job description and SERS' organization chart to determine the Internal Auditor's independence;
 - Tested a sample of 12 internal audits performed during the audit period to determine if the Internal Auditor was effectively evaluating internal controls and management was taking appropriate corrective actions as necessary;
 - Interviewed the Internal Auditor; and
 - Reviewed the Board's Audit Committee meeting minutes to determine if the committee is providing appropriate and sufficient oversight of the internal audit function.

The IFS fiduciary review of this task area is contained in Section III, I-A of Appendix B. IFS reviewed and commented upon SERS' governance documents, Board and committee structure, information technology as it relates to investments, and SERS' Audits, Reporting, and Compliance (ARC) Office. We reviewed and tested Board ethics and conflict of interest matters, Board training, and the independence of SERS' internal audit function. Accordingly, taken together, both reports provide a comprehensive perspective on SERS' organizational structure and resources.

Except where noted below, we have concluded that SERS' Board and staff have generally fulfilled SERS' stated mission by providing sound administration and oversight of investment activities. Furthermore, SERS' development of detailed written policies and procedures outlining day-to-day administrative and investment operations and its use of technology to assist in monitoring performance activities in the areas of, for example,

²⁹ 65 Pa.C.S. § 1101.1 *et seq.*

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investment manager portfolio holdings and securities class action claims greatly assisted us in documenting and obtaining an understanding of SERS' operations.

However, as discussed in our audit findings, we also found several instances in which SERS' policies, procedures, and operations require improvement to enhance the System's overall efficiency and effectiveness. Specifically, we have concluded as follows:

- SERS' Board policies regarding conflicts of interest require improvement to ensure that the policies properly reflect the fiduciary duties of Board members of a public pension plan like SERS;
- SERS did not maintain a formal training program for its Board members or sufficiently track the number of training programs attended by each Board member; and
- SERS' Internal Audit Office lacked organizational independence.

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Board Ethics and Conflicts of Interest

Elected and appointed officials hold important positions of public trust. While serving as trustees of a public pension fund on the SERS Board, such elected and appointed public officials also have a fiduciary duty to act in the best interest of plan members. This duty, conferred upon Board members by Section 5931(e) of the SERS Retirement Code,³⁰ includes not only the duty of loyalty and utmost good faith, but also the obligation to invest and manage the fund monies for the exclusive benefit of the plan members. In addition, as overseers of large taxpayer-supported asset portfolios, the Board members act in the capacity of public officials and as such have an ethical duty to the public. SERS Board members are held to the provisions of the Ethics Act,³¹ in addition to the Governor's Code of Conduct³² or the Legislative Code of Ethics³³ (Legislative Code), as applicable depending upon the role they play within their professional capacities within Commonwealth government.³⁴

Due to the nature of the investment culture, where one person could have a stake in numerous business ventures vying for the same investment money, oversight of investment decisions must be rigorous, especially when taxpayer dollars are at stake. Reasonable transparency of the decision-making process is imperative in order to maintain public confidence.

For this aspect of our audit, we conducted testing to determine what actions individual Board members took to avoid any decision-making practices, particularly with respect to contracting and investments, which were or could appear to be in conflict with the individual Board member's fiduciary duty to act in the best interest of the SERS members. Specifically, we:

- Reviewed all Board meeting minutes from January 2001 through December 2004;
- Observed all Board meetings held between our opening of fieldwork in April 2005 and our close of fieldwork in May of 2006; and

³⁰ 71 Pa.C.S. § 5931(e).

³¹ 65 Pa.C.S. § 1101.1 *et seq.*

³² 4 Pa. Code § 143.1 *et seq.* (Executive Order 1980-18, as amended).

³³ 46 P.S. § 143.1 *et seq.*

³⁴ SERS' Bylaws, adopted on December 8, 2004, incorporate provisions of the Ethics Act, the Legislative Code, and the Governor's Code of Conduct.

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- Evaluated the actions Board members took to disclose any relationships they had with parties that conducted business with SERS and/or the SERS Board.

Finding 1.1 – SERS' Board Policies Regarding Conflicts Of Interest Require Improvement To Ensure That The Policies Properly Reflect The Fiduciary Duties Of Board Members Of A Public Pension Plan Like SERS.

SERS' Bylaws, adopted on December 8, 2004, incorporate provisions of the Ethics Act. Based on our review and testing, we have concluded that the current Ethics Act does not sufficiently address conflict of interest issues related to Board members acting as fiduciaries for the Commonwealth's public pension funds. Because the Board's policies contained in SERS' Bylaws merely reflect the Ethics Act provisions regarding conflicts of interest, the Bylaws are ineffective for addressing conflicts that arise for Board members acting in their fiduciary capacities.

As interpreted by the courts in Pennsylvania, the Ethics Act provision prohibiting, for example, public officials from engaging in the "acceptance of improper influence"³⁵ requires such egregious and clear-cut violations that the provision does not adequately encompass the standards that should be applicable to pension plan trustees with fiduciary duties.³⁶ In fact, the acceptance of improper influence requires that a public official accepting campaign contributions must have an actual "understanding" that his vote will be influenced thereby.³⁷

Furthermore, the provisions of the Ethics Act and the various codes of conduct established by the executive and legislative branches of state government may very well be sufficient to address the conflict of interest issues facing public officials in the

³⁵ The Ethics Act provision, 65 Pa.C.S. § 1103(c), prohibiting a public official from soliciting or accepting anything of monetary value based on any understanding that the public official's vote or other conduct would be influenced thereby refers to such conduct as the "acceptance of improper influence."

³⁶ See, e.g., *Snider v. Thornburgh*, 496 Pa. 159, 176, 436 A.2d 593, 602 (1981), in which the Pennsylvania Supreme Court affirmed the Commonwealth Court's decision that the Ethics Act's prohibition on the acceptance of improper influence "merely prohibits the buying and selling of votes and influence."

³⁷ Section 1103(c) of the Ethics Act, 65 Pa.C.S. § 1103(c), provides as follows: "No public official, public employee or nominee or candidate for public office shall solicit or accept anything of monetary value, including a gift, loan, political contribution, reward or promise of future employment, based on any **understanding** of that public official, public employee or nominee that the vote, official action or judgment of the public official or public employee or nominee or candidate for public office would be influenced thereby." [Emphasis added.]

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ordinary course of their duties to meet the needs of the constituencies that elect them or those whom they are appointed to represent. However, while such elected or appointed officials are acting in their fiduciary capacities on the SERS Board, they are necessarily held to a higher standard statutorily imposed by the Retirement Code.

The Association of Public Pension Fund Auditors (APPFA), in its Model Ethics Policy, supports the concept of greater accountability and transparency.³⁸ According to APPFA, the model policy, dated November 30, 2005, captures many of the best ethical practices in the industry. The policy requires all covered parties to avoid any decision-making practices, particularly with respect to hiring, contracting, or investments, which are or could appear to be conflict of interest or “pay-to-play” practices.³⁹ APPFA designed the policy to foster unquestioned public confidence that public pension plans operate with integrity and prudence.

It is vital that the SERS Board members as well as the investment advisory consultants and investment managers they hire observe the highest ethical standards, including the avoidance of “pay-to-play” practices. Monitoring the inter-relationships between consultants or managers and the decision-makers on the SERS Board in order to identify the existence of actual or perceived “conflicts of interest” should be a shared responsibility by the SERS Board Secretary and Board members as well as their consultants and managers.

During our audit period, SERS’ Board members who are elected officials received campaign contributions from investment management, law, brokerage, accounting, and other firms that had business dealings with SERS. We researched and observed Board

³⁸ Since being established in 1991 by four internal auditors from separate states, the Association of Public Pension Fund Auditors has grown to over 70 member organizations, including the largest public employee retirement systems in 37 states and Canada. SERS has been a member of APPFA for more than ten years.

³⁹ “Pay-to-play” is a practice whereby a business or individual is compelled to contribute to the political campaigns of elected officials in order to gain favor in receiving or retaining government business. It is notable that the U.S. Securities and Exchange Commission (SEC) has made various attempts to more stringently regulate investment advisors because of serious concerns about how pay-to-play practices can undermine the integrity and fairness of the government contracting process. In fact, the SEC was so concerned that in 1999 it proposed rules that would have prohibited an investment advisor from providing paid advisory services to a government client for two years after the advisor or any of its affiliates makes a contribution of more than \$250 to state treasurers, comptrollers, or other elected officials who can influence the selection of an advisor. Although the SEC was not successful in adopting the rule, the proposal has led the industry to adopt measures to better self-monitor advisors’ practices to help avoid pay-to-play practices.

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meetings and found that the Board members generally abstained from voting or participating in discussions on matters for which the public could have perceived that a conflict of interest existed.

However, because the Ethics Act's definition of "conflict of interest" requires that the public official receive an actual "private pecuniary benefit" through his/her actions⁴⁰ and neither the Ethics Act nor SERS' Bylaws contain a monetary threshold amount for required disclosure, there were certain instances in which contributions that were received did not necessarily have to be disclosed so that the other Board members, the staff, and the public could be apprised of the relationships individual Board members had with the firms doing business with SERS.⁴¹ Furthermore, our auditors observed during certain Board meetings they attended that members may have been uncertain or may have misunderstood when it is necessary for them to abstain from speaking in favor of a matter or recusing themselves from voting under the provisions of both the Ethics Act and SERS' Bylaws.

We are not suggesting that Board members who also hold public office should be prohibited from receiving campaign contributions. However, the Board members' fiduciary duty to act with absolute loyalty and utmost good faith in protecting and enhancing plan members' funds and to invest and manage the Fund moneys for the exclusive benefit of the members make it imperative for the Board to strive for greater transparency regarding campaign contributions.⁴² For example, although the Ethics Act, as noted earlier, provides no specific monetary thresholds for what constitutes a conflict of interest, nothing would prevent the Board from determining the amount of a campaign contribution that would trigger the requirement that Board members recuse themselves from voting.

For these reasons, the SERS Board should establish standards that go considerably beyond ensuring compliance with minimum statutory requirements. The

⁴⁰ Section 1102 of the Ethics Act, 65 Pa.C.S. § 1102, defines "conflict of interest," in relevant part, as follows: "Use by a public official or public employee of the authority of his office or employment or any confidential information received through his holding public office or employment for the **private pecuniary benefit** of himself, a member of his immediate family or a business with which he or a member of his immediate family is associated." [Emphasis added.] A "private pecuniary benefit" would involve a public official or public employee receiving a personal financial gain or profit by virtue of his office/employment or from confidential information derived therefrom.

⁴¹ The necessity for a recusal is a determination that each individual Board member must make for himself or herself on the basis of the Ethics Act and the SERS' Bylaws.

⁴² 71 Pa.C.S. § 5931(e).

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procedures should provide a workable process for identifying, minimizing, and resolving conflicts of interest and the lack of clarity about what the improper acceptance of influence entails so that Board members can effectively fulfill their fiduciary duties while maintaining SERS' independence and integrity.

Recommendations

We recommend that, to assist the individual Board members in their self-monitoring and reporting efforts, the Board should address the issue of conflicts of interest by issuing guidelines for Board members and their designees that exceed those in the Ethics Act, the applicable codes of conduct, and SERS' Bylaws. At a minimum, the Board should:

- Define a conflict of interest as it specifically pertains to a Board member's fiduciary duty, including establishing a minimum campaign contribution amount that would trigger action by the Board member and indicating under what circumstances a Board member should publicly disclose a potential conflict, abstain from voting, and disclose on the record the nature of the potential conflict;
- Require the Board's Secretary to obtain copies of all campaign finance reports that the Board members who are elected public officials are required to file with the Department of State, so that the Board Secretary can assist Board members in identifying specific instances in which a member's vote would violate the conflict of interest policy; and
- Require all investment advisory consultants and investment managers to provide an up-to-date comprehensive disclosure statement of all campaign contributions made by principals or employees of their investment firm to Board members within the past ten years to the Board's Secretary each time that consultant or manager makes a presentation before the Board, so that the Board Secretary can assist Board members in complying with the conflict of interest policy.

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SERS' Response

WILL CONSIDER: Staff will research this issue by assessing the policies and procedures utilized by other public pension funds and will then advise the Board. Currently, Board members generally adhere to an informal recusal policy that exceeds Ethics Act guidelines.

Department of the Auditor General's Comments on SERS' Response

The Department of the Auditor General is pleased that SERS will consider our recommendations and we strongly encourage their implementation. The Department does not discount the efforts SERS indicates it is making to ensure that its Board members are adhering to an informal recusal policy that exceeds Ethics Act guidelines.

We note, however, that even the *appearance* of a conflict of interest can have serious repercussions for the confidence and trust that SERS' members and the public have in the integrity of the SERS Board as a whole. Therefore, as outlined in our recommendations, it is in the best interest of SERS and the SERS Board to develop and approve a formal, written conflict of interest policy with well-defined guidelines, including a minimum campaign contribution threshold for recusals. It is also essential that SERS and the SERS Board undertake steps to ensure that the SERS Board Secretary and the Board's consultants and managers assume responsibility for helping Board members to monitor when they must take steps to recuse themselves under the terms of the formal conflict of interest policy.

IFS' Response

IFS did not respond to this finding.

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Board Member Orientation and Training Efforts

New member orientation and training for SERS' Board members is essential for allowing them to carry out their fiduciary duties. Because investment opportunities and portfolio management techniques change rapidly, it is difficult to find any single investment approach that does not soon become outdated. Therefore, Board members must be knowledgeable about Board policies and procedures and a broad range of legal, financial, and investment issues in order to carry out their fiduciary duties.

Central to the fulfillment of a Board member's fiduciary duty is the obligation to participate in the activities of the Board and to be informed on issues and topics that may impact SERS. Therefore, appropriate orientation of new Board members and a training program is essential.

A July 2000 report of the Association of Public Pension Fund Auditors, which was endorsed by the Government Finance Officers Association (GFOA),⁴³ supports the need for meaningful public pension plan board member orientation and training:

Training: Another method to help ensure the competency of staff and trustees is to provide an appropriate orientation for new board members and staff and continuing education for all board members and staff. New board members are often initially educated through an orientation process and receive on-going education by attending appropriate conferences and seminars. In addition, the investment staff and agents of the system may use portions of board meetings to further educate the board on investment related issues.⁴⁴

For this aspect of the audit, we performed the following:

- Reviewed Board Members' Reference Manual and documentation related to the actual orientation each new Board member should have received; and

⁴³ The Government Finance Officers Association provides education, resources, and networking opportunities to support high standards in finance for governmental entities.

⁴⁴ Association of Public Pension Fund Auditors, *Public Pension Systems: Statements of Key Investment Risks and Common Practices to Address Those Risks*, July 2000, p. 17.

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- Reviewed documentation of Board member training to determine the trainings' appropriateness to the Board members' fiduciary duties.

Finding 1.2 – SERS Did Not Maintain A Formal Training Program For Its Board Members Or Sufficiently Track The Number Of Training Programs Attended By Each Board Member.

SERS' Board members are expected to understand the issues and problems facing SERS, so that the Board can develop, implement, and monitor policies to guide the administration of SERS. Therefore, each Board member and his/her designee should be properly oriented and educated to fulfill his/her obligations to the SERS members.

Based on our audit test work, we determined that all new SERS Board members are given a Board Member Reference Manual. In addition, each new member, regardless of previous investment experience, is provided with a Microsoft PowerPoint presentation of the "SERS' Board Member and Legislator Orientation Program." Therefore, it appears that SERS is providing its new Board members with adequate orientation when they join the Board.

However, for our four-year audit period, we found no evidence that SERS maintains a formal training program for its Board members. In fact, SERS does not have a training policy and does not track how much training each Board member receives.

SERS' contract with its general investment advisory consultant contains a provision requiring the consultant to provide educational seminars or training to the Board and Investment Office staff regarding investment issues affecting the Board specifically and public pension plans and institutional investors generally.⁴⁵ The contracts for the alternative investments consultant⁴⁶ and real estate investment consultant⁴⁷ contain similar educational training clauses.

SERS maintained a list of "Board Member Education" presentations made to the Board during or immediately after Board meetings. The general consultant and SERS'

⁴⁵ Agreement for General Investment Consultant, May 31, 2003, Section 4, Consultant's Services, Sub-section E(8).

⁴⁶ Agreement for Alternative Investments Consultant, May 1, 2003, Section 4, Consultant's Services, Subsection J, Other Resources on Investment Related Issues, paragraph 4.

⁴⁷ Agreement for Real Estate Investment Consulting Services, July 1, 2004, Section 4, Consultant's Services, Subsection G, General, paragraph 3.

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investment staff made some of these presentations, while others were made solely by the general consultant or other consultants. In the case of all but one presentation, the training topics were related to SERS' investment reviews, programs, surveys, and guidelines. The one exception occurred on September 10, 2002, when the SERS Investment Office made a presentation to the Board regarding corporate governance and sound reporting practices.

Although these presentations were made available to Board members, a Board member training record was not maintained. Such a document would clearly show which Board members attended the educational presentations, the dates attended, the seminar locations, the topic of each presentation, and the number of hours attended.

SERS' training program should be more formally organized and developed to ensure that specific training objectives and goals are clearly identified and attained. SERS should adopt a formal training policy, which identifies basic investment classes initially provided to new members and gradually include intermediate classes, and ultimately provide advanced investment classes/presentations. Finally, the SERS formal training policy should include the minimum level of annual training each Board member and his/her designee is expected to obtain.

Recommendations

We recommend that SERS' staff develop, with the Board's approval, a formal Board member training program, including objectives and guidelines for new and existing Board members to include minimum annual training requirements. The training program should include basic investment classes for new members and gradually add intermediate classes and advanced sessions. Additionally, SERS should continue with in-house educational presentations, including a review of the prudence standard to which the Board members must adhere,⁴⁸ while at the same time maintaining educational training records for each Board member.

SERS' Response

CONCUR: Staff will document existing policies for orienting new Board members and providing ongoing training to existing Board members.

⁴⁸ See a further discussion of this issue in Findings 2.3 and 2.4 in Chapter 2 of this report.

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However, setting minimum annual training requirements may be unrealistic as training needs must be personalized for each member.

Department of the Auditor General's Comments on SERS' Response

The Department of the Auditor General is pleased that SERS concurs with our recommendations and will be implementing them. We note that personalizing training for Board members by offering basic, intermediate, and advanced classes for Board members depending upon their investment backgrounds does not preclude the establishment of a minimum annual training requirement and an accompanying record-keeping procedure for tracking the number of training hours each Board member receives each year. In fact, these objectives are complementary in that the training program can consist of: 1) a minimum overall number of mandated training hours that each Board member must attain annually; 2) a points-value assigned to each training unit (i.e., session/course) with more advanced units being given a greater value; 3) an attendance tracking system; and 4) a session/course offering that comprises a blend of basic, intermediate, and advanced training opportunities. This would allow all SERS Board members, regardless of their prior investment experience, to meet the Board's minimum annual training requirement without hampering each individual member's ability to choose training at the level of difficulty he or she requires, and would also provide SERS with a comprehensive record of Board members' education and training.

IFS' Response

IFS did not respond to this finding.

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SERS' Internal Audit Function

The purpose of our review of SERS' internal audit function was to determine if the Internal Audit Office was fulfilling its responsibilities in compliance with the professional standards (Standards) established by the Institute of Internal Auditors (IIA). To accomplish this task, we obtained and reviewed the following:

- Job descriptions and the formal charter that governs the Internal Audit Office;
- Organizational charts for each year during the audit period;
- Documentation of the qualifications and continuing education of the Internal Audit Office during the audit period;
- Policies, procedures, practices and other pertinent information used by SERS' Internal Audit Office; and
- A sample of 12 audits that were completed by the Internal Audit Office during the audit period.

In 1983, SERS established an Internal Audit function that organizationally reports to the SERS' Audits, Reporting and Compliance section. The IIA defines an "internal audit activity" as:

A department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organization's operations. The internal audit activity helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.⁴⁹

The SERS' Internal Audit Office joined the Association of Public Pension Fund Auditors more than 10 years ago. Although APPFA does not require its members to abide by IIA standards, it does recommend following IIA standards in its proposed internal audit charter.

⁴⁹ Institute of Internal Auditors, *International Standards for the Professional Practice of Internal Auditing*, Glossary.

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Our review of audits completed by the Internal Audit Office found that these audits were completed in accordance with IIA standards relating to planning, performing the engagement, reporting the results, and due professional care. We also found that the staff of SERS' Internal Audit Office obtained the continuing education needed to enhance their professional development.

The responsibilities of SERS' Internal Audit Office include annual audit plan preparation, potential risk exposure evaluations, internal control reviews, coordination and support of audits performed by independent financial auditors and external auditors, consultation on internal controls for new and existing systems, conducting performance audits as necessary, and performing special projects as directed by the Board's Audit Committee.⁵⁰

Finding 1.3 - SERS' Internal Audit Office Lacked Organizational Independence.

During our audit period, we found that SERS' Internal Audit Office operated in an environment that did not permit the internal auditors to have complete audit independence. As a result, the internal auditors' ability to serve management and the Board was potentially compromised and such activity operated contrary to best practices established by the IIA. IIA Standard 1100, "Independence and Objectivity," defines "independence" as:

The freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement, functional and organizational levels.

Additionally, IIA Standard 1110, "Organizational Independence," states:

The chief audit executive should report to a level within the organization that allows the internal audit activity to fulfill its responsibilities. The internal audit activity should be free from interference in determining the scope of internal auditing, performing work, and communicating results.

Finally, SERS' Statement of Investment Policy addresses the independence of the internal auditor.⁵¹ Section IV.C. of the policy provides as follows:

⁵⁰ SERS' proposed Internal Audit Charter and ARC's Mission Statement were adopted on January 31, 2004.

⁵¹ The policy was adopted on April 21, 2004, and amended on October 27, 2004.

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The internal auditor reports directly to the Executive Director and, if in the opinion of the internal auditor circumstances warrant, may report directly to the Board. The internal auditor is independent of SERS' operational activity and is responsible for providing objective audit and review services for the entire plan, including the Investment Office.

As noted in the IIA Standards and the Board's own policy, the independence of the internal audit function is of utmost importance if this audit function is to effectively accomplish its mission.⁵² We found not only that the Internal Audit Office lacked independence, but also that SERS' practice was inconsistent with its Statement of Investment Policy. Specifically, the internal auditor neither reported directly to the Executive Director nor the Board, as required by SERS' policy.

During the audit period, staff members of SERS' Internal Audit Office reported to the Director of Auditing, Reporting and Compliance, while they also audited ARC, thereby creating an independence issue. Our examination of the twelve internal audit reports prepared for the period of October 2002 to December 2004 revealed that the Director of Audits, Reporting, and Compliance and not the Chief Internal Auditor signed the reports during the period. Our review further disclosed that in two instances, the Internal Audit Office's independence and objectivity was compromised when the ARC Director signed the 2003 and 2004 audit reports of the ARC office itself.

The independence of the internal audit function can only be effectively accomplished by assigning organizational oversight of the internal auditors to a level within the organization that allows the auditors to independently fulfill their responsibilities. This oversight responsibility should be assigned to the Board's Audit Committee. Specifically, the Audit Committee should have the oversight authority to appoint, compensate, and oversee the work of the internal audit function.

⁵² A 2006 IIA brochure entitled, "The Audit Committee: Purpose, Process, Professionalism," suggests that oversight of the internal audit function should be coordinated through a dual reporting relationship. Specifically, the brochure states:

To ensure transparency and thwart collusion and conflict of interests, best practice indicates that the internal audit activity should have a dual reporting relationship. The chief audit executive (CAE) should report to executive management for assistance in establishing direction, support, and administrative interface; and to the audit committee for strategic direction, reinforcement, and accountability.

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IFS shares our concern regarding the independence of the Internal Auditor. In fact, IFS recommends that SERS “establish the internal audit activity as a functional unit that is independent of the organizational activities it is supposed to audit.”⁵³

We also found that, during our four-year audit period, SERS' Internal Audit Office operated without an approved charter. Although SERS' Internal Audit Office had prepared a proposed charter defining its purpose, authority, and responsibility, including a mission statement in accordance with IIA Standard 1000, the charter had never been approved by the full SERS Board.⁵⁴ A Board-approved charter would strengthen and formalize the position of the Internal Audit Office by receiving the full endorsement of the Board.

Recommendations

We recommend that:

- SERS realign its current organizational structure so that the Internal Audit Office reports to both the Executive Director and the Board's Audit Committee. Additionally, the Internal Auditor should periodically update SERS' Board and senior management on the Internal Audit Office's purpose, authority, responsibilities, and performance relative to its audit plan. Such a status update should include an overview of the status of significant risk exposures and control issues, governance issues, and other matters needed or requested by the Board and senior management.
- As part of this organizational realignment, the Board's Audit Committee should assume the responsibility for:
 - Assuring and maintaining, through the organizational structure of the organization and by other means, the independence of the internal audit process;
 - Ensuring that there are no unjustified restrictions or limitations placed on the internal audit staff;

⁵³ See IFS SERS' Report I, Section I-A, “Organizational Structure and Resources,” p. 45

⁵⁴ Staff informed us that the charter was reviewed and approved by the Audit Committee but was never presented to the full Board for approval.

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- Reviewing with management and the Internal Auditor the charter, objectives, plans, activities, staffing, budget, qualifications, and organizational structure of the internal audit function; and
 - Reviewing the effectiveness of the internal audit function, including compliance with the Institute of Internal Auditors' most recent standards.
 - Finally, to strengthen the position of the Internal Audit Office, its charter should be presented to the SERS Board for approval consistent with the IIA's Standard 1000.

SERS' Response

WILL CONSIDER: While no internal audit organization will ever achieve complete independence we believe the current organization and reporting for SERS' IA function effectively meets the Generally Accepted Government Auditing Standards (GAGAS) independence requirements. We are aware that the small size of SERS' Internal Audit Department makes it more difficult to achieve independence and it is for this reason that SERS has taken a number of additional actions to assure effective independence. These actions include: 1). Formation of an audit committee with an approved Audit Committee Charter; 2). Quarterly meetings with the Audit Committee, which includes status updates of the audits in process and presentations of completed audit reports; 3). Development of an agency-wide risk assessment using the COSO [Committee of Sponsoring Organizations of the Treadway Commission] methodology. The risk assessment is the basis for the Annual Audit Plan; 4). Recent completion of a Peer Review; and 5). Annual Financial Audit completed by an independent accounting firm. In addition to these actions, staff is discussing the possibility of realigning certain functions within ARC and working with the Comptroller's Office to include other ARC functions in the Comptroller's audit universe. Finally, SERS' Internal Audit Department does, in fact, have a formal charter, which we believe meets the requirements of GAGAS and was presented to the Audit Committee. However, the Charter was not presented to the full Board for its approval. The Charter will be presented to the Board for approval.

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Department of the Auditor General's Comments on SERS' Response

The Department of the Auditor General is pleased that SERS will be implementing our recommendation that the SERS' Internal Audit Department's charter be presented to the Board for approval and that SERS will consider our other recommendations. Additionally, we are pleased that SERS has begun a peer review process and look forward to the long-term continuation and enhancement of the process.

We also note that, in the first bullet of our recommendations, we recommend that SERS should realign its current organizational structure so that the Internal Audit Office (or Chief of Internal Audits) should report to the Executive Director and to the Board's Audit Committee (i.e., the Board). We note that, although Section IV.C. of SERS' Statement of Investment Policy requires that the Chief of Internal Audits report to the Executive Director or the Board, SERS' Internal Audit Office reported to the Director of Audits, Reporting and Compliance during the audit period, rather than directly to the Executive Director or the Board. Therefore, had SERS been in compliance with its Statement of Investment Policy, there would not have been a need for this recommendation.

Furthermore, the annual financial report completed by an independent accounting firm that SERS lists as one of a number of "additional actions" it has taken to "assure effective independence" is required by Section 5902(n) of the State Employees' Retirement Code.⁵⁵ Moreover, because a financial audit may or may not include a review of internal audit independence, having a financial audit does not necessarily ensure internal audit independence.

IFS' Response

IFS did not respond to this finding.

⁵⁵71 Pa.C.S. § 5902(n), which provides as follows: "Independent audit.--The board shall provide for an annual audit of the system by an independent certified public accountant, which audit shall include the board's accrual and expenditure of directed commissions."

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Chapter Two Legal Provisions Governing SERS' Investment Operations

Pennsylvania has had a retirement system for its public employees since as early as 1923. Established by Act 331 of 1923, SERS was governed by a retirement board consisting of five members who were responsible for overseeing the retirement plan created by the law. Membership on the board at that time included: the Secretary of the Commonwealth, the State Treasurer, one member appointed by the Governor, and two members of the "retirement association" (as the System was then called).

SERS is governed by the State Employees' Retirement Code,⁵⁶ which was enacted by Act 31 of 1974 and which recodified and amended an earlier law governing SERS adopted in 1959 (Act 78 of 1959). Through the adoption of Act 31 of 1974, the retirement board's membership increased from 5 to 11 members and it became an "independent administrative board."⁵⁷ The Board is responsible for administering the retirement fund and has fiduciary responsibility for managing the fund in accordance with the SERS Retirement Code.

Objectives and Methodology

Our objective was to review the legal provisions that govern SERS' investment operations and determine if there are instances in which the provisions may restrict SERS' independence or hamper its ability to achieve its mission.

To accomplish this objective, we specifically examined:

- How legal provisions governing SERS' investment operations impacted its independence⁵⁸ and its ability to achieve its mission;
- Whether SERS' policies and procedures consistently referenced the prudence standard with which SERS has determined its Board must abide; and

⁵⁶ 71 Pa.C.S. § 5101 *et seq.*

⁵⁷ 71 Pa.C.S. § 5901(a).

⁵⁸ Please note that our analyses and determination that SERS is not hampered by its current organizational placement within the executive branch of Commonwealth government and that, in fact, the pension plan and its members benefit from this organizational placement differs from the conclusion reached by IFS. Please see our responses to IFS' SERS Report I and II.

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- Whether the prudence standard in the Retirement Code, which was adopted in 1974, is adequate to reflect the prudent investor rule contained in the Uniform Prudent Investor Act as adopted in 1994.

Accordingly, we completed the following major tasks:

- Reviewed the pertinent legal provisions of the SERS Retirement Code;
- Reviewed the provisions of the Commonwealth Attorneys Act⁵⁹ and relevant case law;
- Reviewed the provisions of the Administrative Code pertaining to the Commonwealth's budget procedures;⁶⁰
- Prepared and analyzed the results of a survey of 28 other states' public employee and public school employee pension systems to determine their level of independence from the executive branch of state government with regard to budgetary, personnel, procurement, and legal services;
- Reviewed the prudence language in the SERS' Retirement Code and SERS' policies and procedures for clarity and consistency of use of the standard;
- Reviewed the prudence language in the Uniform Prudent Investor Act (UPIA), Pennsylvania's "Prudent Investor Rule"⁶¹ to which all fiduciaries, trusts and guardians under the jurisdiction of the orphans' court are subject, and the prudence language in the Uniform Management of Public Employee Retirement Systems Act (UMPERSA); and
- Interviewed appropriate SERS staff.

The IFS fiduciary review of this task area is contained in Section III, I-C of Appendix B. Although we examined similar aspects of SERS' operations, including legal, budgetary, and procurement independence, our results and conclusions differed more from IFS here than in any other common objective.

⁵⁹ 71 P.S. § 732-101 *et seq.*

⁶⁰ 71 P.S. § 229 *et seq.*

⁶¹ 20 Pa.C.S. § 7201 *et seq.*

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Although the SERS Board is an “independent administrative board,” SERS itself is not an independent agency of Commonwealth government. As such, it receives significant benefits that can be derived from the managerial, administrative, legal, and financial support that are provided by the Governor’s Office of Administration (OA), the Governor’s Office of the Budget (OB) and the Governor’s Office of General Counsel (OGC). However, SERS and its Board are also subject to some resulting restrictions. An example of the restrictions that were pointed out by staff members of SERS during interviews with our auditors includes the fact that there have been certain instances in which staff has felt constrained by its inability to hire an outside law firm to assist with real estate transactions without OGC approval. The staff indicated that, although there may have been two or three instances in recent years in which it found the process for obtaining the services of an outside law firm with highly specialized real estate related expertise to be cumbersome and lengthy, the current Chief Counsel has implemented a procedure that has assisted in significantly mitigating any such burdens and delays.

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Finding 2.1 – Although SERS Is Subject To Oversight By The Governor's Office Of Administration (OA), OA Appears To Hamper Neither SERS' Independence To Make Investments Nor Its Mission.

Despite the fact that the Retirement Code designates the SERS Board as an "independent administrative board," certain provisions of the Retirement Code make it apparent that SERS was not intended to be an independent agency. For example, while the Retirement Code permits the Board to establish the compensation of all investment professionals, the compensation of all other officers and employees of the Board not covered by collective bargaining are to be established "consistent with the standards of compensation established by the Executive Board of the Commonwealth."⁶² Furthermore, the Retirement Code provides that the SERS Board "shall, **through the Governor**, submit to the General Assembly annually a budget covering the administrative expenses of this part."⁶³ [Emphasis added.]

None of the provisions of the Retirement Code appear to hamper SERS and its Board's ability to make investments they deem appropriate or to prevent the fulfillment of SERS' mission. Moreover, because the restrictions to which SERS is subject under OA's jurisdiction appear to be entirely administrative in nature, OA's oversight does not appear to hamper SERS' independence to make investments or its ability to achieve its mission. In fact, SERS' staff did not provide any examples of how the Retirement Code or OA may have undermined SERS' ability to make investments, constrained its investment strategy, or prevented it from attaining its mission. The constraints SERS faces appear to be those customarily encountered in the normal course of the operations of an agency of government. On the other hand, it is readily apparent that OA provides SERS and its Board with considerable advantages in terms of consulting services and other assistance with operational issues, including, among other things, human resource management, employee relations, employee training, and employee management.

⁶² 71 Pa.C.S. § 5902.

⁶³ See 71 Pa.C.S. § 5902. Please note that it appears that this reference to submission of SERS' budget "through the Governor" was added to make it readily apparent that SERS' budget is subject to the jurisdiction of the Governor's Office. It must be noted, however, that the Governor, the Lieutenant Governor, and every Commonwealth agency, including those over which the Governor has no jurisdiction (e.g., the Department of the Auditor General or the Liquor Control Board), submits financial and programmatic information to the Secretary of the Budget for purposes of preparation of the budget pursuant to 71 P.S. § 230 and that the Governor submits the budget to the General Assembly on behalf of these parties and agencies pursuant to 71 P.S. § 233.

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Some of the major advantages and disadvantages of retaining the current structure in which OA provides support to the administrative operations of SERS and its Board are as follows:

Table 3. Advantages and Disadvantages of the Current Structure that Provides for OA Oversight of Administrative Matters

Advantages	Disadvantages
SERS and its Board are subject to the provisions of all Executive Orders, Management Directives and Administrative Circulars, which can help to guide them in how to conduct their business with regard to, for example, human resource management and employee training.	SERS and its Board are subject to all of the restrictions contained in the Executive Orders, Management Directives and Administrative Circulars, including the Governor's Code of Conduct, which can lead to the need for obtaining additional approvals and at times, certain resulting delays.
SERS and its Board can rely upon the Secretary of Administration and indirectly the Governor in the implementation of policies, practices, procedures and new initiatives, which can provide them with valuable guidance and support in the areas of, for example, management information systems (establishment and maintenance of technology networks) and labor relations and collective bargaining.	SERS and its Board are subject to the oversight of the Secretary of Administration and indirectly the Governor, which may result in them having to obtain additional approvals or not gaining approval for the adoption of certain administrative policies, practices, procedures, and new initiatives.
SERS and its Board can rely upon OA personnel to assist with the managerial issues that arise in their day-to-day operations. For example, OA's Office of Management Consulting is available to perform program evaluation and assessment and issue a related report.	SERS and its Board are subject to OA oversight with regard to managerial initiatives and decisions, which may result in them having to obtain additional approvals or not gaining approval for the certain managerial initiatives and decisions.
SERS and its Board can rely upon OA's Office of Human Resources for assistance with personnel matters, including but not limited to the following: employee recruitment, employee benefits, payroll, time and attendance, employee classification and pay, and labor relations.	SERS and its Board are subject to oversight by OA's Office of Human Resources in matters of employee classification and salaries and in the size of their complement, which may result in having to obtain additional approvals or not gaining approval for certain employee classification, salary, and complement requests.
SERS and its Board can rely upon OA assistance to help ensure proper employee	SERS and its Board may be at times be required to obtain OA approval or have to

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Advantages	Disadvantages
training and providing access to a wide array of reference materials.	coordinate with OA for certain training programs they wish to provide their staff members.
SERS and its Board can rely upon OA as well as the Governor's Office of the Budget for assistance with formulating SERS' annual budget.	SERS and its Board are subject to oversight by OA and the Governor's Office of the Budget with regard to SERS' annual budget, which directly impacts on the size of the budget.
SERS and its Board can rely upon OA's Office for Information Technology for assistance with their computer and technology issues.	SERS and its Board are subject to oversight by OA's Office for Information Technology, which may constrain their ability to institute their own information technology initiatives.

In conclusion, SERS and its Board can greatly benefit from the vast resources that OA and, more indirectly, OB and the Governor's Office as a whole can provide. At the same time, SERS and its Board may be more constrained in the policies, practices, procedures, and new initiatives they adopt than they would be if SERS were an entirely independent agency. However, given the lack of examples cited by SERS' staff of how they are impacted by OA's oversight, it appears that any constraints that may exist solely impact on administrative matters. In addition, it must be noted that OA oversight may provide pension plan members with some additional assurances that there are checks and balances on SERS' staff and Board.

Furthermore, based on the results of a survey that we conducted with the assistance of the National Association of State Retirement Administrators, the vast majority of the state pension systems that responded have limited or only partial independence in terms of budgetary, personnel, and procurement authority. Please see Table 4 for a summary of the responses to our survey and Appendix A for a detailed presentation of responses.

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Table 4. Summary of Survey of Other States' Pension Systems' Budgetary, Personnel, and Procurement Autonomy.⁶⁴

Degree of Autonomy	Total Number of Systems Other Than Pennsylvania	Public Employee Pension System	Teacher's/School Employee Pension System
<u>Complete</u> ⁶⁵	6	Colorado, Massachusetts, Missouri, Ohio,	Ohio ⁶⁶
<u>Limited</u> ⁶⁷	11	Arkansas, Florida, Idaho, Mississippi, Nebraska, New Mexico, Oklahoma, Oregon, South Dakota, Wisconsin, Wyoming	N/A
<u>Partial</u> ⁶⁸	11	Georgia, Indiana, Iowa, Kansas, Louisiana, Maryland, Nevada ⁶⁹	California, Louisiana, Massachusetts, Ohio ⁷⁰

⁶⁴ The Department received responses from 28 state pension systems including: 23 state public employee pension systems, 4 state teacher pension systems, and 1 state school employees' retirement system. The Department also received responses from three municipal pension systems. The Department's survey instrument is reproduced in Appendix A.

⁶⁵ "Complete" autonomy is generally defined for purposes of this audit report as independence in all three areas (budgetary, personnel, and procurement) examined.

⁶⁶ The membership of this pension system, known as the Ohio School Employees' Retirement System, does not include teachers.

⁶⁷ "Limited" autonomy is generally defined for purposes of this audit report as independence that is not absolute for any of the three areas (budgetary, personnel, and procurement) examined.

⁶⁸ "Partial" autonomy is generally defined for purposes of this audit report as absolute independence or at least some independence in one or two of the three areas (budgetary, personnel, or procurement) examined.

⁶⁹ Georgia – Procurement; Indiana – Personnel; Iowa – Some Procurement; Kansas – Some Personnel; Louisiana – Procurement and Some Personnel; Maryland – Some Procurement; Nevada – Some Personnel.

⁷⁰ California – Some Personnel; Louisiana – Procurement and Some Personnel; Massachusetts – Personnel; Ohio (Ohio State Teachers Retirement System) – Budgetary and Some Personnel.

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Recommendation

We recommend that SERS make more of a concerted effort to work closely with OA in order to ensure that the impact of any administrative limitations is diminished. For example, SERS could select a staff member who would act as an OA liaison charged with regularly updating the System, the SERS Board, and OA on any problems that SERS may be experiencing with administrative issues and hold regularly scheduled monthly or quarterly meetings with OA to work through issues on an ongoing basis.

SERS' Response

WILL CONSIDER: Staff will continue to monitor the processes involved and make the appropriate adjustments deemed necessary to address any deficiencies noted in the process.

Department of the Auditor General's Comments on SERS' Response

The Department of the Auditor General is pleased that SERS will address our recommendation by continuing to monitor the administrative processes it faces under OA's jurisdiction. We reiterate that, because the constraints that SERS faces through the oversight of OA appear to be those customarily encountered in the normal course of the operations of an agency of government, SERS will readily be able to address any deficiencies it identifies through the adoption of an established method of regular communication and coordination with OA, such as through the appointment of one of its staff members as an OA liaison.

IFS' Response

In Chapter Two, DAG states, "Moreover, because the restrictions to which SERS is subject under [the Office of Administration ("OA")]s jurisdiction appear to be entirely administrative in nature, OA's oversight does not appear to hamper SERS' independence to make investments or its ability to achieve its mission. . . . The constraints SERS faces appear to be to be customarily encountered in the normal course of the operations of an agency of government."

While it may be accurate to describe the constraints SERS operates under as "administrative," that characterization does not diminish the significance of those constraints. Being subject to outside control over

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core functions such as personnel, procurement and budgeting has the potential to impact adversely SERS' investment operations. In addition, while such constraints may be typical "in the normal course of operations of an agency of government," SERS is different from typical government agencies. Its expenses are paid from SERS' assets rather than general revenues, and the SERS Board is subject to a rigorous standard of fiduciary responsibility, with a duty of loyalty to the System's members which applies only to retirement systems, not to the typical government agency. As explained in our Report, these distinctive features render it appropriate for SERS to be relieved of these constraints. DAG's own summary of the results of its survey of other state pension systems, shown in Table 4 of the Audit Report, confirms that only 11 of the 28 surveyed systems reported that, like SERS, they had no independent authority over procurement, budgeting and personnel.

DAG also avers "that OA oversight may provide pension plan members with some additional assurances that there are checks and balances on SERS' staff and Board." In our view, proper checks and balances are provided by a diverse Board, representative of the several stakeholders in the System⁷¹, and by the Retirement Code's fiduciary responsibility provisions. We do not believe it is appropriate for a governmental body that does not stand in a fiduciary relationship to the SERS members, and which is therefore responsive to concerns extraneous to SERS, to act as a "check and balance" on the System's fiduciaries.

* * *

Appendix A-Table 2 – Survey Responses to Independent Authority Questions – Table 2 of the DAG Audit Report [Appendix A] points out several instances where the IFS survey results (reported in the SERS Report II – Table II-G-I) differ from the results DAG obtained (e.g. Iowa, Mississippi, Nevada, Ohio State Teachers, Oregon). IFS notes that the survey results it reported in Table II-G-I regarding independent authority were based on the customized peer groups' responses to questions in the IFS survey as well as empirical statutory research. We believe some

⁷¹ IFS Footnote: In our Report we have addressed issues regarding the composition of the Board.

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differences may be attributable to interpretation and others may be due to differences in the specific survey questions used.⁷²

Department of the Auditor General's Comments on IFS' Response

Pennsylvania's public employee retirement system has been part of the executive branch of Commonwealth government since 1923. The retirement system has been governed by an "independent administrative board" since SERS was established by Act 31 of 1974. It is apparent that the General Assembly intended for SERS to be subject to a certain level of oversight by agencies of the executive branch and have ready access to the services and support that such agencies can provide while, at the same time, being governed by a Board that is independent and free to make investment decisions without undue outside influences. Given the fact that SERS can readily demonstrate that it is a well-functioning state retirement system with considerable investment achievements, it appears that the General Assembly has been successful in accomplishing this task.

In fact, despite repeated requests by the Department of the Auditor General, IFS has been unable to provide any evidence that SERS' current organizational placement has caused actual or tangible constraints on the ability of the SERS Board to make investments or achieve its mission. However, IFS continues to advocate overturning longstanding precedent by seeking to have SERS extracted from the executive branch without regard to unnecessary taxpayer expense, difficult transitional and long-term administrative issues, or the potential negative consequences that reducing oversight of SERS could cause for SERS' members. Recent investment scandals in the private sector involving fiduciaries serving on corporate boards support the conclusion that the benefits of some oversight by outside entities cannot be overstated. We acknowledge that SERS may be different from "typical government agencies." However, it is essential that there be a proper balance of operational oversight of the system and unhampered discretion by the Board to make investment decisions as intended by the Pennsylvania General Assembly. Furthermore, we note that although IFS states its belief (p. 124 of the IFS SERS Report II) that an arrangement could be made to allow SERS to continue using the services of, for example, the Governor's Office of Administration and the Governor's

⁷² IFS Footnote: For example, DAG's Table 2 reflects that Ohio STRS does not have independent procurement authority. IFS' Table II-G-I reports that Ohio STRS does have independent procurement authority (however, it is noted in a footnote that it does not have independent authority to select outside law firms). In response to the IFS survey Ohio STRS reported that it has independent authority for general overhead (e.g. computers, office space, telephones), investment managers, the investment consultant, IT services, the actuary, but not for law firms or auditors.

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Office of the Budget to the extent that such services are still needed, IFS provides no further explanation of how such an arrangement would actually work, nor does it provide an example of another state agency or instrumentality of the Commonwealth that has such an arrangement in place.⁷³

Based on the results of our survey of 80 retirement systems from all 50 states, to which we received 28 responses from state retirement systems, only six of the 28 respondents reported having absolute independence in all three operational areas we examined: budgetary, personnel, and procurement. Of the other 22 respondents, a total of 11 reported not having absolute independence in any of the three areas (which is the category in which SERS falls) and the remaining 11 reported absolute or at least some independence in only one or two of the three areas. These survey results support our conclusion that most other state retirement systems have the same or a similar degree of autonomy as SERS. IFS states in its response that “DAG’s own summary of the results of its survey of other state pension systems, shown in Table 4 of the Audit Report, confirms that only 11 of the 28 surveyed systems reported that, like SERS, they had no independent authority over procurement, budgeting and personnel.” This statement by IFS cannot be supported in that none of the respondents to our survey reported having “no independent authority” over these three areas. In fact, a total of 22 or a majority of the respondents fell into the category of at least some authority in the three areas reviewed.

As pointed out in Table 2 in Appendix A of our report, our survey results differed from those of IFS in certain instances. We acknowledge that some of these differences are attributable to interpretation of the survey respondent’s specific responses and differences in our survey questions. We also note, however, that in contrast to IFS we strictly relied upon the survey respondent’s individual responses and did not conduct our own “empirical research” as IFS did by reviewing the statutes of state retirement systems to determine if IFS agreed or disagreed with a system’s interpretation of its own governing statute.

⁷³ We also note that, despite IFS’ statement on page 124 of its SERS Report II that SERS currently provides OGC with reimbursement for the legal services it received, we verified with SERS’ staff that SERS **does not** reimburse the Governor’s Office of General Counsel for the legal services it receives. The sole exception involves reimbursement for the services provided by hearing examiners.

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Finding 2.2 –The Governor’s Office Of General Counsel (OGC) On The Whole Appears To Present No Impediments That Hamper SERS’ Independence To Make Investments Or Its Mission.

The SERS Retirement Code provides that the Attorney General is the legal advisor of the Board.⁷⁴ However, Section 502 of the Commonwealth Attorneys Act transferred the powers and duties of the Attorney General in this regard to the Governor’s Office of General Counsel.⁷⁵

A 1988 decision by the Commonwealth Court of Pennsylvania makes it apparent that PSERS and its Board (and by implication, SERS and its Board, which are governed by identical statutory provisions pertaining to the identity of the Board’s legal advisor) must obtain their legal advisors from OGC and that both PSERS and SERS are part of the executive branch of state government.⁷⁶ Some of the major advantages and disadvantages of retaining the current structure in which OGC provides legal support to the operations of SERS and its Board are as follows:

⁷⁴ 71 Pa.C.S. § 5901(e).

⁷⁵ 71 P.S. § 732-502 (enacted through Act 164 of 1980).

⁷⁶ In *Davis v. Pittsburgh National Bank*, 120 Pa. Cmwlth. 453, 458, 548 A.2d 1326, 1327 (1988), the Commonwealth Court held that a private contract that a former deputy attorney general had entered into with PSERS to provide legal services to its board violated the Commonwealth Attorneys Act (Act) and ordered the attorney to pay restitution. The Court noted that, under Section 102 of the Act, 71 P.S. § 732-102, an “executive agency” is defined as, “[t]he Governor and the departments, boards, commissions, authorities and other officers and agencies of Commonwealth government, but the term does not include...any independent agency.” *Id.* at n.7. Furthermore, the Court stated, “Section 102 [of the Act] specifically enumerates eighteen ‘independent agencies.’ Although the Code...established the System’s Board as an ‘independent administrative board’...the Board and System are not identified in the section as independent agencies.” *Id.* at n.8.

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Table 5. Advantages and Disadvantages of the Current Structure that Provides for Legal Support from OGC

Advantages	Disadvantages
SERS' Chief Counsel reports directly to the Governor's General Counsel and, therefore, can 1) obtain valuable information about the possible government-wide implications of his/her actions, and 2) obtain beneficial assistance and support for bringing about the enactment of SERS' legislative initiatives.	Because SERS' Chief Counsel is subject to the oversight of the Governor's General Counsel, he/she may be somewhat restricted in the actions he/she takes.
The OGC attorneys who provide legal services to SERS and its Board are subject to all policies and procedures of OGC, which may serve as guides in their practice.	The OGC attorneys are subject to the restrictions imposed by the OGC policies and procedures.
The OGC attorneys who provide legal services to SERS and its Board have access to OGC's internal legal intranet, which provides access to a vast amount of information about all areas of practice and offers sample pleadings, briefs, and other helpful legal documents.	No apparent disadvantage
The OGC attorneys who provide legal services to SERS and its Board can readily consult with and utilize the advice of attorneys in any agency under the Governor's jurisdiction.	No apparent disadvantage
The OGC attorneys who provide legal services to SERS and its Board can attend OGC's Continuing Legal Education courses on a vast array of topics.	No apparent disadvantage.

It is apparent that SERS and its Board can benefit greatly from the vast resources that OGC as a whole can provide. At the same time, SERS and its Board may be somewhat constrained by OGC policies and procedures. To the extent that these constraints do not comprise mere administrative limitations, they could be dealt with by, for example, giving SERS' Chief Counsel more latitude to make certain types of decisions without the need for approval from the General Counsel on a case-by-case basis. It must also be noted that OGC oversight may provide pension plan members with some additional assurances that there are checks and balances on the SERS' staff and Board members.

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If SERS determines that it is problematic to have OGC provide it with legal services, SERS should, with appropriate written justification, seek approval from the General Counsel to grant the SERS' current Chief Counsel and his assistants independence from OGC. In the alternative, SERS could seek authorization from the General Counsel to hire a chief counsel and various assistants, perhaps through a memorandum of understanding.

As discussed in Finding 2.1, we conducted a detailed survey of 28 other public pension systems on issues of independence. With regard to requirements for obtaining prior approval from a higher governmental authority before hiring and terminating legal staff, or before hiring outside legal counsel, the results of our survey indicate that only five (the Oregon Public Employee Retirement System, the Florida Retirement System, the Georgia Employee Retirement System, the Wyoming Retirement System, and the Idaho Public Employee Retirement System) of the 28 state pension systems that responded must receive some form of actual outside approval for hiring and terminating legal staff and for contracting for their own private legal counsel. A total of ten indicated that they do not have absolute authority to hire legal staff and a total of eight do not have absolute authority to terminate their legal staff. Please see Appendix A for additional details, including survey questions and responses.

Recommendations

We recommend the following:

- SERS' staff, particularly its legal staff, should make more of a concerted effort to work closely with OGC in order to help diminish any delays and unnecessary burdens that may arise as the result of OGC policies and procedures. One example of how to accomplish such increased cooperation includes the possibility of seeking an agreement with the Governor's General Counsel to provide SERS' Chief Counsel with more latitude to make certain types of decisions without the need for approval on a case-by-case basis.
- In the alternative, if SERS determines that it is problematic to have OGC provide it with legal services, SERS should, with appropriate written justification, seek approval from the General Counsel to grant SERS' current

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Chief Counsel and his assistants complete independence from OGC,⁷⁷ or SERS could seek authorization from the General Counsel to hire a chief counsel and various assistants, perhaps, through a memorandum of understanding.

SERS' Response

WILL CONSIDER: The process used by OGC for the selection of outside legal counsel to assist SERS' advisors with real estate transactions had, in the past, been lengthy and cumbersome. A procedure for selection of counsel is now in effect that generally enables a timely selection of experienced counsel. The Legal Office will continue its efforts to improve the process for approval of outside counsel to avoid recurrence of the instances where a delay has occurred.

Department of the Auditor General's Comments on SERS' Response

The Department of the Auditor General is pleased that SERS will consider our recommendations and indicated that it now has a procedure in place that SERS has been able to demonstrate does generally permit for timely selection of experienced counsel to assist SERS' advisors with real estate transactions. We also acknowledge that any effects of potential conflicts of interest that can arise between SERS and the Governor's Office have been dealt with through OGC's existing procedure for providing authorization to SERS to hire its own separate counsel on a case-by-case basis, which has on occasion been utilized by SERS. Should SERS determine that it is necessary for SERS legal staff to obtain complete independence from OGC, we note that a Memorandum of Understanding could function as a valid, defensible negotiated agreement during any gubernatorial administration.

IFS' Response

DAG presents in Table 5 a list of the "Advantages and Disadvantages of the Current Structure that Provides for Legal Support [for SERS] from OGC." IFS agrees that the items identified as "Advantages" can benefit SERS, but it is not clear that those advantages, such as the availability of

⁷⁷ SERS has occasionally availed itself of OGC's current practice of granting SERS authorization to hire its own separate counsel on a case-by-case basis.

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OGC attorneys to consult with SERS and Continuing Legal Education courses, would not be available if SERS' attorney was an appointee of, and accountable solely to, SERS.

Department of the Auditor General's Comments on IFS' Response

We reiterate our disagreement with IFS' recommendation that the SERS Board should seek, and subsequently implement, legal authority to hire a staff attorney who would be appointed by and serve at the pleasure of the SERS Board, with administrative reporting responsibility to the Executive Director or, until such time as legislation is enacted, that SERS seek a memorandum of understanding ("MOU") with the General Counsel providing for such authority. Because IFS has indicated that the Board, the Executive Director, and the investment staff have been pleased with the quality and timeliness of the Chief Counsel's support for the investment functions and IFS has not provided any specific examples of instances in which SERS' Chief Counsel has had a conflict of interest in serving SERS and the Board, there does not appear to be any justification for the SERS Board to go through the time and expense of pursuing a change to state law. In addition, it is not clear why an MOU is necessary because OGC already provides authorization for SERS to hire its own separate counsel on a case-by-case basis, which the SERS has exercised on occasion.

Furthermore, we disagree with IFS that an independent counsel appointed by and solely accountable to SERS could avail itself of participating in OGC's continuing legal education courses unless IFS obtains the explicit permission of the General Counsel. Moreover, we strongly disagree that such an independent counsel could continue to consult with OGC without raising serious concerns about unnecessary conflicts that would in all likelihood arise between the advice and opinions rendered by such OGC attorneys and the SERS independent counsel.⁷⁸

⁷⁸ It must be noted that SERS would require statutory or General Counsel authority to hire an independent counsel.

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Finding 2.3 - SERS Has Not Been Consistent With Regard To Identifying The Prudence Standard To Which It Has Determined The Board Is Subject.

Under the “Prudent Man” or the “Prudent Person” rule, the trustee was under an affirmative duty to the beneficiary to: “make such investments and only such investments as a prudent man would make of his own property having a view of the preservation of the estate and the amount and regularity of the income to be derived,” “to conform to the statutes, if any, governing investments by trustees,” and “to conform to the terms of the trust” unless there was a conflicting provision in the trust or statute.⁷⁹ However, the law that developed under the prudent man rule began falling into disfavor in the 1990s because of the rule’s tendency to:

(1) focus upon the propriety of each asset in isolation rather than as an integral part of a portfolio; (2) focus upon preservation of nominal value of a principal rather than upon maintenance of purchasing power; (3) prohibit certain investments entirely; (4) provide a safe harbor for certain investments; (5) deter the fiduciary from delegating management; and (6) deter the fiduciary from acquiring new types of investment products.⁸⁰

In 1999, the Pennsylvania General Assembly amended the Probate, Estates and Fiduciaries Code⁸¹ (Probate Code) by adopting the “Prudent Investor Rule”⁸² through Act 29 for all fiduciaries, trusts, and guardians subject to the jurisdiction of the orphans’ court. This rule, which is an adaptation of the Uniform Prudent Investor Act promulgated by the National Conference on Uniform State Laws and adopted in 1994, represents a modernization of the “outdated ‘prudent man’ standard, where each investment would individually be judged to be prudent or imprudent” to one in which “the total portfolio

⁷⁹ Jerold I. Horn, “Prudent Investor Rule, Modern Portfolio, and Private Trusts: Drafting and Administration Including the ‘Give—Me—Five’ Unitrust,” *Real Property, Probate and Trust Journal*, April 1998, p. 3. *See also In re Lohm’s Estate*, 440 Pa. 268, 273, 269 A.2d 451, 454 (1970), in which the Pennsylvania Supreme Court reiterated the long-standing rule that the fiduciary of the trust funds of an estate (one that falls under Probate, Estates and Fiduciaries Code, 20 Pa.C.S. § 101 *et seq.*) in Pennsylvania was “required to use such common skill, prudence and caution as a prudent man, under similar circumstances, would exercise in connection with the management of his own estate” and that, if he has “greater skill than that of a man of ordinary prudence, then the fiduciary’s standard of care must be judged according to the standard of a man with his special skill.”

⁸⁰ Horn, *ibid.*, p. 5.

⁸¹ 20 Pa.C.S. § 101 *et seq.*

⁸² 20 Pa.C.S. § 7201 *et seq.*

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...is reviewed and not any investment in isolation.”⁸³ Section 7203 of the Probate Code provides the following with respect to the “Prudent Investor Rule”:

(a) General rule.--A fiduciary shall invest and manage property held in a trust as a prudent investor would, by considering the purposes, terms and other circumstances of the trust and by pursuing an overall investment strategy reasonably suited to the trust.

(b) Permissible investments.--A fiduciary may invest in every kind of property and type of investment, including, but not limited to, mutual funds and similar investments, consistent with this chapter.

(c) Considerations in making investment and management decisions.--In making investment and management decisions, a fiduciary shall consider, among other things, to the extent relevant to the decision or action:

1. the size of the trust;
2. the nature and estimated duration of the fiduciary relationship;
3. the liquidity and distribution requirements of the trust;
4. the expected tax consequences of investment decisions or strategies and of distributions of income and principal;
5. the role that each investment or course of action plays in the overall investment strategy;
6. an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries, including, in the case of a charitable trust, the special relationship of the asset and its economic impact as a principal business enterprise on the community in which the beneficiary of the trust is located and the special value of the integration of the beneficiary's activities with the community where that asset is located;

⁸³ Daniel M. Miller, Mark Bookman, and Carolyn D. Duronio, “Prudent Investor Rule Changes Investment Duties of Pennsylvania Fiduciaries,” *The Philadelphia Lawyer*, Spring 2000, p. 1.

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7. to the extent reasonably known to the fiduciary, the needs of the beneficiaries for present and future distributions authorized or required by the governing instrument; and
 8. to the extent reasonably known to the fiduciary, the income and resources of the beneficiaries and related trusts.⁸⁴

In addition, under Section 7204(a) of the Probate Code, the fiduciary of an estate must, as a general rule, seek to “reasonably diversify investments, unless the fiduciary reasonably determines that it is in the interests of the beneficiaries not to diversify, taking into account the purposes, terms and other circumstances of the trust and the requirements of this chapter.”⁸⁵

Fiduciary Duties and Prudence Standard of the SERS Board Members

Section 5931(e) of the SERS Retirement Code states the following, in pertinent part, with regard to the fiduciary duties of the SERS Board:

The members of the board, employees of the board and agents thereof shall stand in a fiduciary relationship to the members of the system regarding the investments and disbursements of any of the moneys of the fund and shall not profit either directly or indirectly with respect thereto. The board may, when possible and consistent with its fiduciary duties imposed by this subsection or other law, including its obligation to invest and manage the fund for the exclusive benefit of the members of the system, consider whether an investment in any project or business enhances and promotes the general welfare of this Commonwealth and its citizens, including, but not limited to, investments that increase and enhance the employment of Commonwealth residents, encourage the construction and retention of adequate housing and stimulate further investment and economic activity in this Commonwealth.⁸⁶

⁸⁴ 20 Pa.C.S. § 7203.

⁸⁵ 20 Pa.C.S. § 7204(a). Please note that this provision requires only reasonable diversification of investments rather than complete diversification as provided for in the Uniform Prudent Investor Act (Miller, Bookman, and Duronio, *ibid.*, p. 3).

⁸⁶ 71 Pa.C.S. § 5931(e).

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Therefore, SERS' Board members stand in a fiduciary relationship with the pension plan members and have the duty of loyalty and the utmost good faith. Board members are also prohibited outright from directly or indirectly profiting from an investment or disbursement of moneys of the Fund. Furthermore, Board members must invest and manage the Fund moneys for the exclusive benefit of SERS' members and consider each investment decision with an eye toward the enhancement and promotion of the general welfare of the Commonwealth and its citizens.

With regard to the prudence standard to which the SERS Board members are subject, Section 5931(a) of the Retirement Code provides as follows:

The members of the board shall be the trustees of the fund. Regardless of any other provision of law governing the investments of funds under the control of the administrative board of the State government, the trustees shall have exclusive control and management of the said fund and full power to invest the same in accordance with the provisions of this section subject, however, to the exercise of that degree of judgment, skill and care under the circumstances then prevailing, which persons of prudence, discretion and intelligence, who are familiar with such matters, exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the funds, considering the probable income to be derived therefrom as well as the probable safety of their capital. The trustees shall have the power to hold, purchase, sell, lend, assign, transfer or dispose of any of the securities and investments in which any of the moneys in the fund shall have been invested as well as of the proceeds of said investments, including any directed commissions which have accrued to the benefit of the fund as a consequence of the investments, and of any moneys belonging to said fund, subject in every case to meeting the standard of prudence set forth in this subsection.⁸⁷

The critical language in this provision is that the Board members' control, management, and investment of the moneys of the fund are subject to "the exercise of that degree of judgment, skill and care under the circumstances then prevailing, which persons of prudence, discretion and intelligence, **who are familiar with such matters**, exercise in the management of their own affairs not in regard to speculation, but in regard

⁸⁷ 71 Pa.C.S. § 5931(a).

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to the permanent disposition of the funds, considering the probable income to be derived therefrom as well as the probable safety of their capital.” [Emphasis added.]

We learned during the course of this audit that SERS has not consistently identified this standard as either the “prudent person” standard or the “prudent investor” standard. In fact, as demonstrated in the following table, while the applicable prudence standard is explicitly referred to as the “prudent person” standard in some SERS documents, it is referred to as the “prudent investor” standard in others.

Table 6. Identification of Prudence Standard in Various System Documents

Document	Standard Identified
Statement of Investment Policy	“Prudent Person”
Alternative Investments Statement of Investment Policy	“Prudent Person”
Comprehensive Annual Financial Report	“Prudent Person”
SERS’ 2005 Budget Report to the House Appropriation Committee in the Summary of the “SERS Investment Policy”	“Prudent Investor”

In September 2005, the Department inquired with SERS’ Office of Chief Counsel about the terminology that office believed was appropriate to describe the prudence standard to which SERS has determined its Board is subject. As a result of this inquiry, SERS’ Office of Chief Counsel initiated a review of this issue in consultation with its PSERS counterpart that lasted more than three months. At that time, our Department was informed in a telephone conversation that both Systems had concluded that the appropriate terminology to be used to describe the prudence language in the SERS Retirement Code was the “prudent investor” standard. In a January 4, 2006, memorandum from the Systems’ two chief counsels addressed to our Department, which summarized the telephone conversation, both Systems’ chief counsels stated as follows, in pertinent part:

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[A]fter separate research on the issue by each of our legal offices, we have each concluded that the standard applicable to each of our boards in making investment decisions is a prudent investor standard....the terms 'prudent investor standard,' 'prudent man standard' and 'prudent person standard' are often used interchangeably and, as applied to the members of our boards, each of these standards would appear to require essentially the same degree of care by our boards in making investment decisions. Because each of SERS' and PSERS' Retirement Codes sets the degree of judgment, skill and care that must be exercised by the respective board regarding investment at the level of prudent persons "who are familiar with such matters" (24 Pa. C.S. §8521(a) and 71 Pa. C.S. §5931(a)), we prefer the term "prudent investor standard," since it is investors who would be "familiar with such matters."⁸⁸

With regard to whether SERS' Statement of Investment Policy should be revised to ensure consistency, the chief counsels stated in their memorandum that, because the terms "prudent person" and "prudent investor" are "often used interchangeably," they did not believe that the policy contained "an incorrect statement." The memorandum, however, goes on to note the following: "However, we will recommend that SERS' and PSERS' documents that specify the prudence standard applicable to investment decisions use the term 'prudent investor standard' to avoid any confusion."⁸⁹

⁸⁸ January 4, 2006 memorandum from the SERS Chief Counsel and the PSERS Chief Counsel, to the Deputy Chief Counsel, Department of the Auditor General, p. 1.

⁸⁹ Ibid., p. 2. It is unclear on what basis the plans' chief counsels came to the conclusion that the two standards are interchangeable for purposes of the fiduciary duties that pertain to members of the boards. It may be based on the fact that Section 7214 of the Probate Code, 20 Pa.C.S. § 7214, pertaining to the "Prudent Investor Rule," provides the following:

The following terms or words of similar import **in the provisions of a trust**, unless otherwise limited or modified, shall authorize any investment or investment strategy permitted under this chapter: 'investments permissible by law for investment of trust funds,' 'legal investments,' 'authorized investments,' 'using the judgment and care under the circumstances then prevailing that persons of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their own funds, considering the probable income as well as the probable safety of their capital,' 'prudent man rule', 'prudent trustee rule', 'prudent person rule' and 'prudent investor rule.' [Emphasis added.]

However, this provision is applicable only to trusts that fall under the jurisdiction of the orphans' court.

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The fact that SERS was apparently unsure until this audit about the appropriate terminology to be used to describe the standard of prudence to which it has determined the SERS Board members are subject raises significant concerns about whether their Board members have been adequately prepared to fulfill the prudence standard.⁹⁰ While IFS has indicated that it agrees with the Systems that they are subject to the “prudent investor” standard, IFS stated in a letter dated February 23, 2006 that because the common law prudent person standard is a less rigorous standard, the terms “prudent person” and “prudent investor” should not be viewed as interchangeable.⁹¹ In addition, IFS has stated that “it was advisable for trustees to obtain the training necessary for them to meet their challenging fiduciary responsibilities.”

Recommendations

We recommend the following:

- SERS should ensure that all of its documents consistently refer to the “prudent investor standard,” which is the prudence standard to which SERS’ Chief Counsel has determined the SERS Board members are subject.
- All SERS’ Board members **and** their designees should be provided with an immediate orientation session, a member orientation packet, and an additional

⁹⁰ We defer to the opinions of the plans’ chief counsels as to which of the two prudence standards their Board members are subject. However, it is notable that the National Council on Teacher Retirement in its recent publication, entitled “Protecting Retirees’ Money,” 5th ed. (June 2005), in discussing the prudence standards to which the retirement systems of all 50 states are subject, stated that PSERS, *which has prudence language in its governing statute that is identical to that of SERS*, is among the minority of teacher state retirement systems that is subject to the “prudent person” standard. The Department notes that the prudence language cited for systems that were determined to be subject to the “prudent investor” standard typically included references to a duty of “diversifying the investments of the retirement system or pension fund so as to minimize the risk of large losses.” According to PSERS, the Council’s study simply reflects PSERS’ response to a survey, rather than the Council’s independent assessment. We were unable to confirm PSERS’ assertion.

⁹¹ February 23, 2006 letter from IFS to the Department of the Auditor General, p. 4. Please note that in response to questions posed by the Chief Counsel of PSERS during a March 6, 2006 teleconference call with IFS, IFS began making a distinction between standards it labels as the “prudent investor” and “prudent expert” standard. IFS then went on to express the opinion that the PSERS Board is subject to the “prudent investor” standard as it pertains to its investment decisions, but that IFS will decline to make any statements about which prudence standard (“prudent person” or “prudent expert”) may apply with regard to other types of decisions that the PSERS Board makes because, in IFS’s opinion, such a determination exceeds the scope of IFS’ review.

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training program about the prudence standard to which they are subject and what it means both in terms of their obligations and their accountability to SERS' members if they do not meet their obligations.

SERS' Response

SERS' Board and SERS' Legal Office were always aware of the prudence standard to which the Board is subject when making investments. The standard is that set forth in Section 5931(a) of the Retirement Code.

The DAG inquiry to which SERS' and PSERS' Legal Offices responded was whether that prudence standard is properly called a "prudent person" standard or a "prudent investor" standard. The question posed to the Legal Offices was prompted by the alternate use of the terms in different SERS documents. The delay in responding to DAG's inquiry was not prompted by any uncertainty as to the standard to which the Board was subject, but rather by a desire to thoroughly research the terminology issue. Indeed, when the question was posed, it was indicated that there was no need for a prompt response.

As was noted in the January 4, 2006 memo that was sent to...DAG by the Chief Counsels of SERS and PSERS, the standard in the Employee Retirement Income Security Act is similar to that applicable to SERS and PSERS and is captioned "prudent man standard of care." It was also noted that Section 7214 of Pennsylvania's Prudent Investor Rule indicates that the terms "prudent man rule", "prudent person rule" and "prudent investor rule" are considered the same for purposes of that act. Despite this apparent use of both terms to refer to the standard to which SERS' Board is subject, SERS' and PSERS' Legal Offices stated that they preferred the term "prudent investor" and indicated that they would recommend that their respective systems use that term in all documents to specify the prudence standard applicable to investment decisions.

Accordingly, we concur with the first recommendation. However, as noted above, the Board is fully mindful of the standard applicable to the Board when making investment decisions. A presentation was made to the Board by IFS covering its various fiduciary obligations, including discussion of the standard of care applicable to its investment decisions, and SERS' Chief Counsel discussed the terminology differences with the Board in an

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executive session to assure that there was no confusion as to the applicable standard. Therefore, there is no need to implement the second recommendation as stated; but such orientation should be included as part of the orientation of any new Board member.

Department of the Auditor General's Comments on SERS' Response

The Department of the Auditor General is pleased that SERS concurs with our first recommendation that all SERS documents should consistently utilize identical terminology to identify the prudence standard to which SERS' Chief Counsel has determined the Board is subject. We note that Section 7214 of the Probate, Estates and Fiduciaries Code, pertaining to the "Prudent Investor Rule" to which SERS refers in its response, involves transitional statutory language to ensure that references to either standard contained in existing trusts are considered the same,⁹² but does not support viewing the standards as interchangeable for any other purpose. In fact, as discussed previously, the "prudent person rule" involves an older standard than the "prudent investor rule," which calls for different considerations by the fiduciary and, thus, are not interchangeable.⁹³

With regard to our other recommendation, the fact that the "prudent person standard" and the "prudent investor standard" involve different fiduciary considerations and the fact that SERS documents were not consistent with regard to identifying the standard as the "prudent person standard" or the "prudent investor standard" raised valid questions and concerns about whether SERS Board members have a thorough understanding about what the prudence language in the SERS' Retirement Code actually requires. We are pleased that SERS' Office of Chief Counsel has thoroughly researched

⁹² 20 Pa.C.S. § 7214, which is applicable to trusts that fall under the jurisdiction of the orphan's court, provides the following: "The following terms or words of similar import **in the provisions of a trust**, unless otherwise limited or modified, shall authorize any investment or investment strategy permitted under this chapter: 'investments permissible by law for investment of trust funds,' 'legal investments,' 'authorized investments,' 'using the judgment and care under the circumstances then prevailing that persons of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their own funds, considering the probable income as well as the probable safety of their capital,' 'prudent man rule', 'prudent trustee rule', 'prudent person rule' and 'prudent investor rule.'"[Emphasis added.]

⁹³ For example, under the "prudent person rule", each investment would individually be judged to be "prudent or imprudent," while under the "prudent investor rule" there is a focus on the total portfolio being reviewed and not any investment in isolation.

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the terminology issue⁹⁴ and note that SERS' response provides some assurances that SERS Board members have been fully apprised of their fiduciary obligations.⁹⁵ We are also pleased that SERS' Chief Counsel has apparently quite recently discussed the standards with the Board in executive session.

IFS' Response

IFS concurs with DAG's recommendation in its Finding 2.3 that it would be appropriate for SERS to use the phrase "prudent investor" in its governing documents to describe the standard of prudence imposed by the Retirement Code.

Department of the Auditor General's Comments on IFS' Response

The Department of the Auditor General is pleased that IFS concurs with our finding.

⁹⁴ Despite contrary inferences that can be drawn from SERS' response, we note that the fact that our finding includes a reference to the period of time in which the SERS' Legal Office conducted its review was not intended to raise questions about their timeliness or responsiveness to our inquiry. It simply makes clear that there was some degree of uncertainty about the proper terminology that should be utilized to identify the prudence language in the SERS' Retirement Code, which helps to explain the inconsistency of the SERS' documents.

⁹⁵ It must be noted that most SERS Board members were not present during the IFS presentation to the Board in which it provided an overview of the prudence standard to which the Board is subject. Furthermore, IFS has expressed varying opinions during the conduct of their fiduciary review as to whether the language in the SERS' Retirement Code reflects a "prudent investor" or "prudent expert" standard.

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Finding 2.4 – It Is Unclear Whether The Prudence Language In The SERS Retirement Code, Which Was Adopted In 1974, Is Adequate To Reflect The Prudent Investor Rule Contained In The Uniform Prudent Investor Act As Adopted In 1994 And Amended Into The Pennsylvania Probate Code In 1999.

An article in *The Philadelphia Lawyer*, a publication of the Philadelphia Bar Association, in Spring 2000, about Pennsylvania's "Prudent Investor Rule" explained that the "rule embraces the key elements of academic modern portfolio theory and fundamentally changes the manner in which Pennsylvania fiduciaries are permitted to invest."⁹⁶ The article also provides an overview of the key elements of the "investment principles," which can be summarized as follows: the donor's intent controls; the overall investment strategy must be prudent; and permissible individual investments are analyzed in the context of the entire trust portfolio, which allows fiduciaries to invest a portion of the trust in investments with greater volatility like hedge funds and venture capital funds. In addition, as discussed earlier, the rule requires that the estate trustees take into account a number of investment considerations, such as, for example, the role that each investment or course of action plays in the trust's overall investment strategy, as well as the requirement that the trustees reasonably diversify their investments.

We determined that the SERS Board appears to adhere to the requirements outlined in the Prudent Investor Rule as it was adopted for estate trustees in Pennsylvania, including the analysis of individual investments in the context of the entire fund portfolio and the reasonable diversification of investments. However, it is highly questionable whether the prudence language in the SERS Retirement Code as adopted in 1974 contains all of the necessary elements to encompass modern portfolio theory and investment diversification principles⁹⁷ as those contained in the "Prudent Investor Rule" adopted for estate trustees in 1999.

Recommendations

Because SERS and the SERS Board have made the determination that they are subject to the "prudent investor" standard, they should seek a legislative change to the provision in the SERS Retirement Code containing the Board members' prudence standard to ensure that it encompasses all of the key elements of the Prudent Investor

⁹⁶ Miller, Bookman, and Duronio, *ibid.* p. 1

⁹⁷ *Ibid.* p. 2

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Rule contained in the Pennsylvania Probate Code as specifically tailored to investments made by the fiduciary board of a public pension plan. Alternately, or in the meantime, SERS should amend their investment policy accordingly.

The General Assembly should, independent of SERS, consider amending the SERS Retirement Code to reflect the Prudent Investor Rule contained in the Pennsylvania Probate Code as specifically tailored to investments made by the fiduciary board of a public pension plan.

SERS' Response

WILL CONSIDER: SERS will consider seeking a legislative change if the opportunity arises.

Department of the Auditor General's Comments on SERS' Response

The Department of the Auditor General is pleased that SERS will consider our recommendations.

IFS' Response

While we are generally comfortable with the Retirement Code's formulation of that standard, we recognize that it could be improved upon by, for example, making specific reference to a duty to diversify the System's investments. In its recommendations following Finding 2.4, DAG recommends legislation "amending the SERS Retirement Code to reflect the Prudent Investor Rule contained in the Pennsylvania Probate Code as specifically tailored to investments made by the fiduciary board of a public pension plan." The Pennsylvania Probate Code's "prudent investor" provisions, like the provisions of the Uniform Prudent Investor Act, identify investment criteria relevant to the investment of private trust assets. In fact, the definition of the term "fiduciary" in the Probate Code specifically excludes "an administrator of a municipal pension or retirement plan. . . ." ⁹⁸

⁹⁸ IFS Footnote: 20 Pa.C.S. § 7201.

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IFS believes that if the Retirement Code is to be amended to render more robust the statute's prudence standard then the prudence formulation in the Uniform Management of Public Employee Retirement Systems Act is more appropriate than the provisions in the Probate Code or UPIA. While there are considerable overlaps between UMPERSA's Section 8 and UPIA's Section 2, and also overlaps, though fewer, between UMPERSA's Section 8 and the Probate Code, the UMPERSA provisions articulate considerations that apply directly to public retirement plans such as "the adequacy of funding based on reasonable actuarial factors" (UMPERSA §8(a)(1)(F)) and "collateral benefits" (UMPERSA § 8 (A)(5)) that do not appear in either UPIA or the Probate Code. In addition, UPIA and the Probate Code state standards such as "other resources of the beneficiaries" (UPIA § 2(c)(6)) irrelevant to the public pension fund arena. In addition, as we explain in our Report, the UPIA standard is based on the conduct of prudent amateurs, while UMPERSA is intended to be more rigorous. DAG's suggestion that the Probate Code provisions be added to the Retirement Code after being "specifically tailored to investments made by the fiduciary board of a public pension plan" can be addressed more directly by adopting the UMPERSA standard, which already reflects such "tailoring."

Department of the Auditor General's Comments on IFS' Response

The Department of the Auditor General is pleased that IFS has stated in its response that the SERS Retirement Code's formulation of the prudence standard could be improved upon by, for example, making specific reference to a duty to diversify SERS' investments.⁹⁹ We note that our recommendation that legislation be sought to amend the SERS Retirement Code to reflect the Prudent Investor Rule contained in the Pennsylvania Probate, Estates and Fiduciaries Code only calls for the adoption of the key elements of that rule as specifically tailored to investments made by the fiduciary board of a public pension plan.

We advocate tailoring the key elements of the Uniform Prudent Investor Act (UPIA) to investments made by SERS because the UPIA has a proven track record having been adopted by the vast majority of states, including Pennsylvania through Act

⁹⁹ IFS also acknowledges this lack of a diversification requirement in its discussion of the SERS Board's prudence standard in IFS SERS Report I.

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28 of 1999. In contrast, the Uniform Management of Public Employee Retirement Systems Act (UMPERSA) was rejected by OGC when it was adopted by the National Conference of Commissioners of Uniform State Laws in 1997 and has only been enacted by two states as a whole. Moreover, UMPERSA's provisions pertaining to considerations that fiduciaries should take into account when making investment decisions do not appear to be as clear-cut and easy to follow as those expressed in the UPIA.

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Chapter Three Investment Advisory Consultants

SERS utilizes two categories of external consultants, namely, investment advisory consultants and actuarial consultants. Investment advisory consultants provide a wide range of services to SERS, including recommending investment objectives, developing investment policies, evaluating investment managers, and monitoring investment portfolios. In short, SERS relies heavily on the expertise and guidance of its investment advisors.

SERS employs three advisory consultants, including a general investment advisory consultant who provides advice on SERS' overall investments and two secondary advisory consultants who provide more specific investment advice relating to alternative and real estate investments.

SERS also has an external consulting relationship with its consulting actuary. Section 5902(j) of the Retirement Code requires the SERS Board to hire an actuary.¹⁰⁰ Within six months of the end of each calendar year, the actuary performs an annual valuation, which SERS uses to determine the employer contribution rate for the following year. Every five years, the actuary also performs an experience study of the fund based on data that includes the mortality, service, and compensation of SERS' members, annuitants, and beneficiaries during the preceding five years. The actuary then uses the results of the experience study to adjust the assumptions used in the annual valuation.

Objectives and Methodology

Our objective was to determine if SERS' policies and procedures intended to act as guidelines in selecting and monitoring investment advisory consultants are adequate and functioning as designed and if the contractual obligations of investment advisory consultants are being met.

To accomplish this objective, we examined the following:

- If SERS awarded investment advisory consultants' contracts in accordance with Pennsylvania laws and regulations;
- If the investment consultants and actuary complied with their contracts; and

¹⁰⁰ 71 Pa. C.S. § 5902(j).

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- If any conflicts of interest were present that could interfere with the investment advisory consultants' ability to provide the best advice to SERS.

Accordingly, we completed the following audit steps:

- Reviewed Pennsylvania laws and regulations that pertain to the selection of SERS' investment advisory consultants and actuaries;
- Examined the four Requests for Proposals (RFP) for investment advisory consultants that SERS issued during the audit period;
- Reviewed the selection committee's due diligence rating process used to review and rank the 22 bids received in response to the above mentioned RFP's;
- Reviewed the annual reports filed with the SEC for all three investment advisory consultants;
- Reviewed the contracts for each of the three investment advisory consultants and the actuary SERS employed during the audit period;
- Examined SERS' policies and procedures to identify any potential conflicts of interest between consultants and investment managers;
- Examined all 12 contractually required reports, during the audit period, generated by the consultants and actuary;
- Reviewed 33 Board meeting minutes during the audit period and attended 7 Board Meetings to observe the consultants' and actuary's interaction with the Board; and
- Interviewed appropriate staff.

The IFS fiduciary review of this task area is contained in Section III, I-D of Appendix B. IFS reviewed and commented upon the services provided by consultants in general, the specific services required by SERS' consultant contracts, and the services actually provided by each SERS' consultant. We tested and reported on SERS' processes for awarding the consultants' contracts and for monitoring contract compliance. Both of our reports describe our efforts to review compliance with SEC regulations concerning consultant conflicts of interest. We also tested for conflicts of interest in this area. Because the approaches were different, the results, although not contradictory, are nevertheless different and should be viewed as complementary and read in this context.

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Finding 3.1 – SERS' Procurement Processes For Investment Advisory Consultants Worked As Intended And The Investment Consultants And Actuary Complied With Their Contracts.

SERS followed the Commonwealth's Request for Proposal (RFP) Process outlined in the Commonwealth's Field Procurement Handbook, Manual Number 215.3, to select and award contracts to consultants. This process is provided for in the Commonwealth Procurement Code.¹⁰¹

In addition to following the RFP Process, SERS established detailed procedures regarding the selection of advisors. These procedures included the use of a selection committee to review all bids that were received from potential consultants. Prior to selecting a consultant, SERS identified potential consultants who were interviewed by the selection committee. Following the interviews, the selection committee ranked the candidates. SERS' Office of Chief Counsel then opened the fee proposals and ranked the bids based on price. After the scores were compiled, the selection committee made a recommendation to the Board and the Board made the final decision on who was selected.

Audit testing of SERS' investment advisory and actuarial consulting contract award process disclosed that the committee adequately reviewed the information that was presented to it and rated each firm based on this information. The firms were also awarded points based on costs and other factors such as meeting Commonwealth equal opportunity requirements.

After all of the factors were examined, the committee drafted a detailed summary of the process and presented a summary report to the Board for review. For the four contracts awarded during the audit period, the firms with the highest cumulative score were awarded the individual consulting contracts.

Test work completed and documentation collected showed that SERS' investment consultants and actuary complied with their respective contracts. Specifically, we verified that the consultants attended Board meetings, assisted SERS' investment staff in completing investment manager searches, participated in the development of the annual investment plans, and responded to information requests from SERS' staff. All of the

¹⁰¹ 62 Pa. C.S. § 518(c).

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consultants also provided SERS with their disclosure forms showing that they were registered with the SEC.

We also conducted test work and verified that the actuary assisted SERS in completing the annual actuarial valuation, made annual recommendations and updated the employer contribution rate, attended board meetings, and assisted the board and SERS' investment staff in preparing the annual financial report.

Recommendation

No recommendation is necessary.

SERS' Response

SERS did not respond to this finding.

IFS' Response

IFS did not respond to this finding.

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Finding 3.2 - SERS Adequately Monitored The Relationships Between Its Three Investment Advisory Consultants And Its External Investment Managers; However, SERS Did Not Require Annual Disclosure Documentation In Its Contracts With The Consultants.

SERS monitored the relationships between the consultants and the investment managers by requiring its investment consultants to submit a copy of an annual report detailing the types of services they provide, the names of businesses to which they provide services, backgrounds of their principals, as well as a list of their other business activities.¹⁰²

We conducted testing to determine compliance with this requirement. Specifically, we requested the annual report for each consultant for all four audit years and interviewed SERS' Director of Audits, Reporting and Compliance. Our review of these annual reports and the interview disclosed that SERS adequately monitored the consultants' relationships with investment managers presented to SERS' Board and that no conflicts of interest existed. In fact, SERS' general consultant does not provide services to a dual customer base, a common practice among investment consultants.

In May 2005, the SEC released a *Staff Report Concerning Examinations of Select Pension Consultants*. This report concluded that consultants should enhance their compliance policies and procedures to include those that ensure the consultants fulfill their fiduciary duties to clients. Pension consultants who are registered are now subject to the new "Chief Compliance Officer Rule" (Rule 206(4)-7 under the Advisers Act).

In response to the SEC report, SERS requested that each of its consultants provide:

- The name of the consultant's compliance officer;
- A copy of the policies and procedures the consultant adopted to comply with Rule 206(4)-7;
- Additional policies and procedures under consideration, as a result of the SEC report; and

¹⁰² SEC Form ADV, Uniform Application for Investment Adviser Registration.

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- A letter representing that the consultant, its principals, and agents are not engaged in activities that provide economic benefit to the firm beyond the fees paid for pension consulting services.

Our review of the documents provided by the three consultants in response to SERS' request disclosed both compliance by the consultants and no potential conflicts of interest. SERS' staff informed us that they would request this information annually from its consultants.

IFS complimented SERS for requesting this information from the general consultant and indicated that SERS' "effort to obtain disclosure and to review reports from its consultants constitutes a best practice on the part of the Fund."¹⁰³ IFS recommends, and we agree, that SERS should amend its contract with the general consultant to include annual disclosure as a contractual requirement.

Recommendation

We recommend that SERS amend the contracts with all three investment consultants to include annual disclosure documentation as a contractual requirement and include such a requirement in future contracts.

SERS' Response

WILL CONSIDER: SERS agrees that obtaining this information on an annual basis is important and valuable. SERS believes that the consultants and external investment advisors can be required, *inter alia*, to produce annual disclosure documentation under the terms of the existing contracts. SERS, however, will negotiate for appropriate disclosure provisions in future contracts.

Department of the Auditor General's Comments on SERS' Response

The Department of the Auditor General is pleased that SERS agrees with our recommendation and will take steps to fully implement it by negotiating appropriate disclosure provisions in future consultant and external investment advisor contracts.

¹⁰³ See IFS' SERS Report I, Section I-D, "Investment Consultants' Responsibilities," p. 104.

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IFS' Response

IFS did not respond to this finding.

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Chapter Four Investment Managers

According to the Government Finance Officers Association, selecting the proper investment manager is a crucial part of managing a pension fund. Given that public pension plans, such as SERS, are large enough to be part of the institutional investor class, they require detailed, logical, and disciplined investment manager selection processes. The processes must be free of personal preference and executed with analysis that combines sophisticated quantitative tools with experienced investment staff resulting in sound, qualitative judgments. According to GFOA guidelines, a due diligence investigation should include the following:

- On-site interviews;
- Review of previous investment performance history of the firm's principals;
- Review of the continuity of the firm's investment staff;
- Review of the firm's performance;
- Analysis of the firm's performance in comparison to peer groups;
- Review of the firm's audited financial statements;
- Review of press reports and SEC filings; and
- Identification of any regulatory and/or licensing issues.¹⁰⁴

In the case of investments, "due diligence" can be described as a process designed to mitigate risks and other factors involved in making investment decisions. All offers that SERS makes to new investment managers should be contingent on the results of a due diligence analysis. Such due diligence analyses are essential for SERS to fulfill its fiduciary duties in carrying out its investment obligations. For investments, due diligence includes the process of research and analysis that takes place in advance of any

¹⁰⁴ "Investment Policy Checklist for Pension Fund Assets," Government Finance Officers Association, Committee on Retirement and Benefits Administration, May 2003, Appendix E, "Guidelines for Selection of External Investment Professionals," provides suggested guidelines that address the selection of investment professionals.

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investment commitment. An investor will either use in-house resources or hire an outside investment advisory consulting firm, or both, to investigate the background of a potential investment manager. The SERS Board relies heavily on both staff and external advisors to carry out its investment and administrative obligations.¹⁰⁵

The data collected from the due diligence review is subsequently presented to the Board. The more information that is made available to decision makers, the better the chances that the most qualified and appropriate investment manager will be chosen.

In today's fast paced and ever changing investment environment, it is imperative that pension plans have a thorough investment monitoring program in place. This monitoring can be completed either by the pension plan's internal staff or by its consultant. Regardless of who completes the monitoring, the more comprehensive the monitoring, the less likely errors and irregularities are likely to occur.

SERS' Selection of Investment Managers

SERS outlined its criteria for selecting investment managers in its Statement of Investment Policy, which the Board reviews and amends periodically. In accordance with SERS' policies and procedures for selecting investment managers, the first phase of the investment manager hiring process is the selection of a list of potential managers, derived from a database of the advisors universe (such as international, domestic, growth, and cap weight). As part of the due diligence process, SERS' consultant and investment staff research the list of potential managers who are aligned with the specific needs of the investment program. This research includes investigations into the backgrounds and histories of the investment manager firms' principals. Research also includes an analysis and verification of previous investment performance. Upon completion of the search, a report detailing the results of the due diligence process for each potential manager is presented to the Board members for their review.

After an initial screening, successful candidates may be invited to discuss their service and give a detailed presentation at a second Board meeting. These presentations typically include the history of the manager's organization, biographies of key team members, assets under management, overall investment philosophy, security selection approach, portfolio construction, buy and sell disciplines, and trading practices. Upon

¹⁰⁵ SERS' Statement of Investment Policy, adopted April 21, 2004, and amended October 27, 2004, Section IV, "Fiduciary Status, Duties, and Responsibilities of Board, Staff, Investment Advisors, Other Agents, and State Treasurer," p. 2.

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completion of the investment manager presentations, the Board will vote on whether or not to hire the manager.

Objectives and Methodology

Our objective was to determine if SERS' policies and procedures intended to act as guidelines in selecting and monitoring investment managers are adequate and functioning as designed and if the contractual obligations, if any, of managers are being met.

To accomplish this objective, we performed the following:

- Reviewed copies of SERS' policies and procedures pertaining to due diligence, investment manager contract monitoring, and investment manager invoice processing;
- Randomly selected a sample of 14 contracts and reviewed the terms and conditions of each;
- Reviewed copies of the investment manager due diligence reports such as the manager's presentation to staff, consultant's due diligence report, and executive interview summary reports compiled by both SERS' staff and consultants for 14 contracts in our sample;
- Reviewed copies of contractually required documentation, such as proof of insurance, for each of the 14 investment manager contracts included in our sample and reviewed this information to determine compliance with contract provisions;
- Interviewed appropriate staff responsible for investments and compliance;
- Reviewed SERS monitoring procedures and reports documenting review activities to verify that investment manager compliance monitoring was being completed;
- Interviewed three staff members from the Pennsylvania Treasury Department regarding prohibited investment transaction reports;

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- Reviewed SERS' investment manager invoice payment process to verify that SERS had implemented sufficient management controls to ensure that vendor charges were properly reviewed and approved prior to payment; and
 - Selected a sample of four managers and reviewed the quarterly invoices to ensure that the management controls were working as intended.

The IFS fiduciary review of this task area is contained in Section III, I-B of Appendix B. IFS reviewed and commented upon SERS' due diligence and monitoring policies and procedures as well as the policies and procedures for investment guidelines. Like IFS, we reviewed SERS' due diligence and monitoring policies and procedures. However, we also tested and reported on SERS' compliance with these policies and procedures as well as tested and reported on SERS' payment of manager investment fees. We did not review investment guidelines. For the common topics reviewed or tested, our results did not differ significantly from IFS and both reports for this task area support each other.

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Finding 4.1 – SERS' Due Diligence Process For Selecting Investment Managers Was Adequate And Appropriately Documented.

Our audit test work found that SERS had adequate policies and procedures for selecting investment managers. Furthermore, SERS' staff and consultants followed the established due diligence procedures in selecting investment managers. We reviewed the due diligence documents of 14 randomly selected managers for compliance with the established manager selection policies and procedures. Test results indicated that SERS' staff and consultants did a thorough due diligence review of potential investment manager candidates prior to recommending them to the Board. IFS reviewed the due diligence process and concluded that SERS' procedures "surpass industry best practices."¹⁰⁶

We verified that SERS' staff and the pertinent consultant researched the manager candidates and appropriately documented their research results for the Board. Research included investigations of the backgrounds and histories of the principals involved in the investment-making decisions of the investment management firms. It also included an analysis and verification of the performance of previous investments made by the principals.

After the consultant and staff performed their due diligence review, several potential investment managers were chosen for recommendation to the Board. An information package containing the results of the due diligence review for each investment manager was given to the Board. Our attendance at Board meetings and our review of Board minutes and resolutions found that the consultant and each of the chosen investment managers made a presentation during public Board meetings; afterwards, the Board members voted on which manager or managers to hire.

Recommendation

No recommendation is necessary.

SERS' Response

SERS did not respond to this finding.

¹⁰⁶ See IFS' SERS Report I, Section I-B, "Due Diligence Procedures," p. 51.

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IFS' Response

IFS did not respond to this finding.

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Finding 4.2 – SERS Implemented Sufficient Policies And Procedures To Adequately Monitor Investment Managers' Performance And To Ensure Compliance With Contract Provisions.

Our review and test work of SERS' investment manager monitoring process found that, overall, SERS' policies and procedures were sufficient to ensure that investment managers were complying with contractual obligations. We focused our detailed testing on determining if SERS' Compliance Office staff adequately monitored the investment managers to ensure that they were performing at or above the benchmarks outlined in the contracts; if the investment managers complied with the reporting and documentation provisions of their contracts; and if the fees the investment managers charged to SERS were in accordance with contract provisions. The specific results of this testing are outlined below.

Performance Monitoring - We determined that SERS' Compliance Office staff conducted ongoing monitoring activities of investment managers, in accordance with established policies and procedures, to ensure continued compliance with contract provisions and to monitor investment performance. SERS' Investment Office staff also attempted to meet with each investment manager at least annually. SERS' monitoring process is detailed in written procedures entitled, *SERS' Monitoring Investments and Advisors Process* and *SERS' Compliance Monitoring Process*, and includes, but is not limited to, the following:

- Monthly or quarterly reviews of manager reports and consultant risk analysis reports to:
 - Evaluate proper diversification, portfolio concentrations, that holdings are consistent with mandate and no prohibited transactions exist; and
 - Analyze performance and examine returns as well as determine whether discussion is necessary regarding under/over performance.
- Periodic formal meetings with investment managers to discuss performance issues, personnel, strategy, and portfolio holdings as well as other pertinent information. Issues discussed at these meetings should be documented.

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IFS also conducted a detailed review of SERS' investment manager monitoring process and concluded that SERS' procedures "comprise a consistent and effective approach to monitoring external managers."¹⁰⁷

We concentrated our testing on the process used by the Compliance Office staff and found that they did a thorough job of using the custodian bank's software program – "Investment Monitor" – to verify that investment managers' portfolio holdings were consistent with contractual mandates. The Compliance Office staff checked all potential prohibited transactions (i.e., those that constitute contract violations) noted on the prohibited transactions report, and responded to the custodian after all such "flagged" transactions were checked. During the audit period, none of the transactions on the prohibited transactions reports, checked by the Compliance Office staff, were determined to be actual contract violations, or prohibited transactions. IFS agreed with our conclusion that the Compliance Office staff did a thorough job and went even further to state that SERS' "extensive compliance program, integrated with the Custodian's systems, represents a best practice."¹⁰⁸

While SERS' investment staff informed us that they do conduct periodic meetings with investment managers, they were unable to provide documentation of these meetings. Staff informed us that, historically, these meetings were not documented. However, subsequent to our audit period, SERS' staff informed us that they have updated their procedures and such periodic meetings are presently being documented.

Reporting/Documentation Compliance – We determined that the 14 investment managers selected for detailed testing provided the contractually required documents for the four-year audit period. Specifically, we verified that the investment managers in our sample submitted:

- proof of errors and omission insurance;
- proof of a fidelity bond;
- proof of registration with the SEC;
- end of year reports on soft-dollars/directed commissions; and

¹⁰⁷ Ibid, p. 55.

¹⁰⁸ Ibid, p. 57.

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- immediate written notification of changes in the manager's/advisor's status, including, but not limited to, modification of business organization and material deterioration of financial condition.

Investment Manager Fees – We reviewed the accounts payable process for investment managers and determined that the process ensured adequate review and approval of invoices. We also determined that the process was sufficient to identify and prevent the payment of erroneous charges. IFS conducted a similar review of the process and they too concluded that “process for approval of manager fees is thorough.”¹⁰⁹ The IFS Report II provides a detailed outline of the actual accounts payable procedures employed by SERS.

While SERS appears to have implemented adequate procedures for the approval of manager fees, we conducted testing to ensure that these procedures were actually followed and found that they were working as intended. Specifically, we tested quarterly invoices totaling over \$1.5 million for a sample of four managers, and verified that each step of SERS' procedures was followed and documented. Additionally, we recalculated the actual fees charged and verified that the fees were in accordance with contract provisions.

Recommendation

No recommendation is necessary.

SERS' Response

SERS did not respond to this finding.

IFS' Response

IFS did not respond to this finding.

¹⁰⁹ See IFS' SERS Report II, Section II-F, “Costs and Fees,” p. 105

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Chapter Five Securities Litigation

An increase in securities litigation is a general trend in the present investment environment and the future may see such litigation increase. The evolution of high profile cases in securities litigation, such as Enron and WorldCom, have started an age of closer scrutiny, more securities regulatory investigations and, ultimately, more securities litigation.

According to the 2004 PricewaterhouseCoopers' study, securities litigation and securities regulatory investigations and enforcement actions increased substantially in 2004. SEC investigations and enforcement actions against companies and their directors and officers reached an all-time high during fiscal year 2003-2004 and continued to rise in 2004. Private securities litigation settlements reached record highs, in terms of numbers of high-dollar settlements and the average and median settlement values. In addition, the impact of the Sarbanes-Oxley Act of 2002 began to be felt by U.S. and foreign companies. By 2004, securities litigation was a global concept.¹¹⁰

The study set forth reasons for why litigation settlements are increasing. The major reasons included the enormous growth of economic damages asserted in private securities class actions, the role of public retirement fund and pension fund fiduciaries and institutional entities as "lead plaintiffs" in class actions, and the involvement of private securities claims against companies involved in accounting scandals and financial frauds.¹¹¹

Finally, the study revealed that the 2004 securities litigation statistics, trends, and events suggest that the future will entail steady, or somewhat increasing, trends in the number of private securities litigation and regulatory enforcement actions.¹¹² Consequently, pension funds, as potential institutional shareholder plaintiffs, must diligently monitor securities litigation in order to fulfill their fiduciary duties.

Another study emphasized that securities litigation strategy is currently driven largely by institutional shareholder plaintiffs. This study noted that "over 75% of the current class actions are headed up by institutional plaintiffs, who are much more active

¹¹⁰ "2004 PricewaterhouseCoopers LLP Securities Litigation Study," p. 1.

¹¹¹ Ibid., p. 7.

¹¹² Ibid., p. 10.

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in settlement discussions and aggressive in seeking individual contributions.”¹¹³ This study also concurred that the future will see an increase in individual securities litigation brought by large shareholders seeking a much greater recovery than that typically afforded in class actions.¹¹⁴

Objectives and Methodology

Our objective was to determine if adequate procedures have been implemented to respond to and recover funds lost as a result of past corporate financial reporting improprieties.

To meet this objective, we sought to determine:

- If SERS had established policies and procedures for the identification and evaluation of potential securities litigation claims, monitoring the litigation process, and appropriately accounting for monies received when a securities litigation claim is settled;
- What securities litigation claims had been initiated during the audit period and if established policies and procedures were followed for identifying, evaluating, and monitoring these actions; and
- The amount of securities litigation monies SERS recovered.

Accordingly, we completed the following audit steps:

- Reviewed SERS' securities policies and procedures in effect during the audit period, including the procedures for identifying and monitoring securities litigation claims;
- Documented information on SERS' Securities Litigation Committee and how the Board fulfilled its fiduciary duties regarding securities litigation claims during the audit period, prior to the establishment of the Committee in 2003;

¹¹³ “Securities Litigation Alert,” February 14, 2005, Fenwick & West LLP, p. 1.

¹¹⁴ Ibid., p. 2.

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- Reviewed and documented the custodian bank's responsibilities in the SERS litigation process;
 - Met with three staff members of the Pennsylvania Treasury Department and documented their responsibilities in the SERS securities litigation process; and
 - Obtained the list of litigation claims that SERS entered into during the audit period and randomly selected six claims and documented the settlement monitoring process to verify that procedures were operating as intended. We also verified that settlement amounts were received and accounted for appropriately.

The IFS fiduciary review of this task area is contained in Section III, I-E of Appendix B. IFS reviewed and commented on the securities litigation process in general and SERS' securities litigation policies and procedures in particular. We reviewed and tested SERS' securities litigation policies and procedures. Essentially, the Department and IFS covered similar aspects of SERS' operations but took different approaches. Accordingly, our results complement each other.

SERS adopted its first securities litigation policy in 1998 with Board Resolution 1998-67. Subsequently, the Board repealed Resolution 1998-67 and adopted its current securities litigation policy on June 4, 2003, with Board Resolution 2003-49. In this policy, the Board established a Securities Litigation Committee to be composed of three Board members. The Securities Litigation Committee is one of three Board standing committees. The Resolution also authorized and directed the Executive Director to issue Requests for Qualifications (RFQs) for law firms to represent or advise SERS in securities litigation. Finally, SERS' legal staff drafted a document entitled, "Proposed Steps in Securities Litigation Process," in April 2004. This document supplemented existing policies and is geared toward the overall litigation process.

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Finding 5.1 – SERS' Board Did Not Formally Adopt Securities Litigation Policies And Procedures.

With the passage of Resolution 2003-49, the Board created the Securities Litigation Committee and granted it the following powers and duties:

- Establish and modify, as it deems desirable, general principles to consider in determining whether SERS should participate in securities litigation and in what capacity, with a general requirement of at least a \$3,000,000 loss to the retirement fund for SERS to seek lead plaintiff status in a class action lawsuit;
- Determine whether SERS should institute securities litigation and, if so, whether it should do so individually or as a lead plaintiff or co-lead plaintiff in a class action lawsuit;
- Engage law firms to represent SERS in a securities litigation claim or to advise SERS in determining whether to prosecute a securities litigation claim (including the capacity in which SERS pursues such litigation), such law firms to be selected from a current list of qualified law firms established by SERS;
- Coordinate efforts with other plaintiffs or potential plaintiffs as the Securities Litigation Committee deems desirable to achieve a better result for SERS; and
- Take such further actions as the Securities Litigation Committee deems necessary or desirable to affect desired results in the exercise of the foregoing powers and to comply with applicable laws and regulations.

While SERS had developed and implemented written procedures for identifying potential securities class action litigation claims, and for monitoring the litigation process during the audit period, we note that SERS prepared revised procedures in April 2004 that were never adopted by the Board. These 2004 revised procedures were documented in SERS' "Proposed Steps in the Securities Litigation Process." Further testing indicated that SERS had implemented the revised procedures even though they were never adopted by the Board.

It is essential that the securities litigation process receive the attention of the SERS Board to ensure that this important function is carried out as intended by the Board, and that there are no misunderstandings among Board members or staff with

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regard to expectations. IFS also recommended that this document be “memorialized by the adoption of a formal resolution.”¹¹⁵

Recommendation

We recommend that SERS formally adopt, by Board resolution, its “Proposed Steps in Securities Litigation Process,” dated April 7, 2004.

Subsequent Event: SERS implemented this recommendation by having the Board formally adopt the “Proposed steps in Securities Litigation process” at its May 2006 meeting.

SERS' Response

COMPLETED: A Securities Litigation Policy satisfying this recommendation was adopted by the Board at the May 31, 2006 Board meeting.

Department of the Auditor General's Comments on SERS' Response

The Department of the Auditor General was aware that SERS adopted the “Proposed Steps in Securities Litigation Process” and noted the adoption of this document in our report as a subsequent event.

IFS' Response

IFS did not respond to this finding.

¹¹⁵ See IFS' SERS Report I, Section I-E, “Securities Litigation Activities,” p. 124.

*A Special Performance Audit by the
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September 2006***Finding 5.2 – SERS' Staff Properly Monitored Securities Litigation Claims.**

SERS developed and implemented detailed monitoring procedures for securities litigation claims. The procedures, which describe each stage of the process, were revised in May 2003 and again in April 2005.¹¹⁶ IFS noted in its report, and we agree, that SERS' claims monitoring process was "well-defined" and "comprehensive." We conducted detailed testing for 6 of the 128 claims that were settled during the audit period and verified that the procedures were implemented and working as intended.

The table below reflects numbers of claims and dollar amounts received for securities litigation claims paid during the audit period.

Table 7. Paid Claims and Dollar Amounts Recovered

Year	Total # of Paid Claims	Total Amount of Funds Recovered
2001	25	\$ 1,474,993
2002	46	\$ 2,349,843
2003	36	\$ 1,570,142
2004	21	\$ 845,021
Totals	128	\$ 6,239,999

SERS reported a total of 175 actual or potential claims during the period January 1, 2001 through December 31, 2004. Of the 175 claims, 128 were identified as "Paid" and 47 claims were listed as either "Pending, Not Filed or Rejected."¹¹⁷ SERS was in the process of seeking lead plaintiff status in the litigation of two companies and was a passive participant (non-lead plaintiff) in all of the other cases.

¹¹⁶ SERS developed the procedures, "Monitoring Class Action Lawsuits" dated May 29, 2003. The revised procedures, ARC's process for "Monitoring Class Actions," was dated April 20, 2005.

¹¹⁷ SERS provided the following definitions of the claim status indicators noted above: "Not Filed" – based on SERS' activity in that security and the eligible claim requirements detailed in the settlement notice, SERS did not have any eligible transactions or losses. "Pending" – A claim has been filed with the claims administrator and it is pending further action (i.e., eventual distribution of settlement funds; rejection by claims administrator). "Rejected" – if, based on the details in the settlement notice, there is any uncertainty whether or not SERS' transactions or losses qualify as an eligible claim, the custodian bank will file the claim on SERS' behalf. The claims administrator will make the final eligibility determination and may reject the claim.

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Our review of the monitoring procedures disclosed that once a securities litigation claim was settled by the court, the SERS' Audits, Reporting and Compliance Section monitored all securities litigation claims and utilized an in-house Excel spreadsheet to track the actual cash proceeds awarded from court settlements. SERS' Office of Financial Management utilized reports from the custodian bank to monitor the amount of claim settlement monies actually received. We reviewed a sample of six class action claims that were classified as "Paid" and reviewed documentation and other evidence. We verified that SERS' staff properly monitored and recorded all settlement payments in accordance with their procedures.

Recommendation

No recommendation is necessary.

SERS' Response

SERS did not respond to this finding.

IFS' Response

IFS did not respond to this finding.

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Finding 5.3 - The Securities Litigation Committee Did Not Document Its Meetings And Only Twice During The Audit Period Were Notations Made In The Board's Meeting Minutes That Securities Litigation Activity Was Discussed.

Board Resolution 2003-49 requires the Securities Litigation Committee to report any recommendation to participate in securities litigation at the next meeting of the Board following any such decisions. Additionally, although SERS designated its Securities Litigation Committee as a standing committee, it only met on an as-needed basis.

We found that the Securities Litigation Committee did not prepare and maintain minutes of its meetings. Furthermore, we found only two instances during the audit period where class action litigation activity was indicated on executive session agendas. These items appeared on the agenda only because SERS was lead plaintiff. Other than on those two occasions, there was very limited documentation of SERS' Securities Litigation Committee activity.

In light of the present securities class action litigation environment, a more formal securities litigation reporting process would be a valuable tool to the Board. It would further outline the Committee's operations with respect to fulfillment of the Board's fiduciary duties regarding class action litigation.

Recommendation

The Securities Litigation Committee should document its meetings in written form.

SERS' Response

CONCUR: Minutes of meetings of the Securities Litigation Committee will be prepared. As to the lack of instances where notations of securities litigation activity was indicated in minutes of the Board's meetings, that is because the minutes would only reflect instances where Board action was required. The Board is regularly given an update on all securities litigation matters, including class action securities litigation, in its executive sessions as part of the Litigation Update agenda item.

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Department of the Auditor General's Comments on SERS' Response

The Department of the Auditor General is pleased that SERS will prepare and maintain minutes for all Securities Litigation Committee meetings.

IFS' Response

IFS did not respond to this finding.

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Chapter Six Pennsylvania Investments

Section 5931(e) of the Retirement Code demonstrates interest by the General Assembly to encourage investment in Pennsylvania businesses as a means to promote community and economic development, in part, as follows:

The [Board] may, when possible and consistent with its fiduciary duties...consider whether an investment in any project or business enhances and promotes the general welfare of this Commonwealth and its citizens, including, but not limited to, **investments that increase and enhance the employment of Commonwealth residents, encourage the construction and retention of adequate housing and stimulate further investment and economic activity in this Commonwealth.**¹¹⁸ [Emphasis added.]

This provision also provides that the General Assembly is to receive annual reports regarding investments in Pennsylvania businesses, and states as follows:

The [Board] shall, through the Governor, submit to the General Assembly annually, at the same time the [Board] submits its budget covering administrative expenses, a report identifying the nature and amount of all existing investments made pursuant to this subsection.¹¹⁹

SERS incorporated this section of the Retirement Code into its Statement of Investment Policy, where it states:

The Board may, when possible and consistent with its fiduciary duties imposed by law, including its obligation to invest and manage the Fund for the exclusive benefit of the members of the plan, consider whether an investment in any project or business enhances and promotes the general welfare of the Commonwealth and its citizens. Where investment characteristics, including yield, risk, and liquidity, are equivalent, the

¹¹⁸ 71 Pa.C.S. § 5931(e).

¹¹⁹ Ibid.

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Board's policy favors investments that will have a positive impact on the economy of Pennsylvania.¹²⁰

As a result of the General Assembly's interest, SERS includes a section of the report dedicated to Pennsylvania investments in its annual budget submission to the Appropriations Committees of the Pennsylvania Senate and House of Representatives.

Objectives and Methodology

Our objective was to evaluate the extent to which SERS had made an effort to invest in and contract with Pennsylvania firms.

To accomplish this objective, we:

- Reviewed SERS' policies regarding investments in Pennsylvania; and
- Reviewed SERS' annual budgets to the General Assembly to determine the type and amount of SERS' investments in Pennsylvania.

This objective is unique to the Department of the Auditor General and is not contained in the IFS fiduciary review reports.

¹²⁰ "Statement of Investment Policy," adopted April 21, 2004, and amended October 27, 2004, Section IV., Subsection A., "Board of Trustees."

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Finding 6.1 – SERS Made A Conscientious Effort To Make Investments In Pennsylvania And Reported These Investments To The General Assembly.

Our review of the budget documents and SERS' policies revealed that SERS' investments in Pennsylvania crossed all investment classes – equity, fixed income, real estate, and alternative investments (venture capital and private equity). The following table provides a summary of SERS' Pennsylvania investments for 2001 through 2004.

**Table 8. Market Value of SERS' Pennsylvania Investments
(amounts in \$ millions)**

Asset Classes	2004	2003	2002	2001
U.S. Stocks	\$ 438.5	\$ 457.4	\$ 315.6	\$ 457.5
Fixed Income	\$ 180.1	\$ 187.6	\$ 131.1	\$ 201.5
Real Estate	\$ 376.1	\$ 370.7	\$ 471.4	\$ 451.6
Venture Capital	\$ 57.5	\$ 47.6	\$ 46.6	\$ 70.9
Private Equity	\$ 96.0	\$ 90.1	\$ 72.4	\$ 70.5
Total PA Investments	\$1,148.20	\$1,153.40	\$1,037.10	\$1,252.00

For each of these asset classes, SERS established Pennsylvania-focused programs.

PA – U.S. Stock Investments

SERS invests in Pennsylvania stocks through two investment managers whose portfolios consist almost exclusively of Pennsylvania companies, as well as through an index fund and through other investment managers whose portfolios include Pennsylvania companies.

SERS has two Pennsylvania-based investment managers who administer portfolios derived from 427 publicly-traded corporations. These corporations either name Pennsylvania as their headquarters and have Pennsylvania employees or have Pennsylvania-based employment exceeding 25% of the total corporate employment. At the end of 2004, these two SERS portfolios were valued at \$367.9 million.¹²¹

¹²¹ SERS' 2005 Budget Report, transmitted to the General Assembly, "Summary of SERS' Pennsylvania Investments," December 31, 2004, p. 1-3.

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Other SERS investment managers include stock in Pennsylvania-based companies as part of their overall portfolio and Pennsylvania stocks are included in a SERS' S&P 500 Index fund. At the end of 2004, these managers' portfolios and the index fund held stock in Pennsylvania companies valued at \$70.6 million.¹²²

PA-Fixed Income

SERS invests in Pennsylvania fixed income securities through the Pennsylvania Capital Fund, commercial mortgages, commercial mortgage-backed securities, and corporate securities issued by Pennsylvania-based companies.

In March 1999, SERS established the Pennsylvania Capital Fund, managed by two Pennsylvania-based managers. As described in the budget documents presented each year to the General Assembly, "The program provides debt financing to support the expansion and growth of Pennsylvania small businesses. The Fund seeks to lend to established, profitable companies in good financial condition with annual revenues between \$10 and \$100 million." At the end of 2004, SERS investments in the Capital Fund totaled \$22.2 million.¹²³

In addition to the Capital Fund, SERS invests in commercial mortgages on industrial, retail, apartment and office complexes within Pennsylvania and in commercial mortgage-backed securities. At the end of 2004, SERS had invested \$6.1 million in commercial mortgages.¹²⁴

At the end of 2004, SERS also held \$6.6 million in commercial mortgage-backed securities and \$145.2 million in Pennsylvania corporate securities, which were in various externally managed bond portfolios.¹²⁵

PA – Real Estate Investments

SERS invests directly in Pennsylvania commercial real estate and timberland through three managers.

¹²² Ibid.

¹²³ Ibid., p. 3.

¹²⁴ Ibid.

¹²⁵ Ibid., pp. 3-4.

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In 1987, SERS began investing in Pennsylvania commercial real estate and has two managers who focus on Pennsylvania real estate. These managers purchase office, retail, warehouse space, apartment, hotel, and senior housing. SERS has also contracted with a manager for the purchase of Pennsylvania timberland.

At the end of 2004, SERS' real estate portfolio contained 82 Pennsylvania properties consisting of office, retail, and warehouse space as well as more than 5,200 apartment, hotel, and senior housing units. Additionally, SERS' real estate portfolio contained several thousand acres of Pennsylvania timberland.¹²⁶

PA – Alternative Investments

SERS uses limited partnerships for its venture capital and private equity investments. These limited partnerships offer potentially greater returns but also carry a greater risk than other SERS investments.

At the end of 2004, SERS venture capital and private equity limited partnerships had invested \$3.6 billion in 113 Pennsylvania companies that employed almost 35,000 employees. Additionally, SERS' limited partnerships had invested in companies outside of Pennsylvania that employed more than 12,500 Pennsylvania residents.¹²⁷

As evidenced by the investments detailed above, it appears that SERS, when possible and consistent with its fiduciary duties, has invested in projects and businesses that have enhanced and promoted the general welfare of the Commonwealth and its citizens.

Recommendation

SERS' Board should continue to make a conscientious effort to invest in Pennsylvania projects and businesses consistent with the requirements of law and its fiduciary duty to SERS' members.

¹²⁶ Ibid., p. 4.

¹²⁷ Ibid., p. 7.

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SERS' Response

CONCUR: The Board will continue to make a conscientious effort to invest in Pennsylvania projects and businesses consistent with the requirements of law and their fiduciary duties to the SERS' members.

Department of the Auditor General's Comments on SERS' Response

The Department of the Auditor General is pleased that SERS concurs with this recommendation.

IFS' Response

IFS did not respond to this finding.

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Appendix A

Pennsylvania Department of the Auditor General Survey

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Background for Survey

The Department of the Auditor General designed and e-mailed a survey to 80 retirement systems from all 50 states. These retirement systems were members of the National Association of State Retirement Administrators. We received responses from 28 systems.

The purpose of our survey was to determine the system's relationship with the governor and/or executive branch regarding the system's personnel, procurement, and budgetary autonomy. We also ask questions regarding the composition of the governing board including total members and number of members elected or appointed by the governor. These last questions also address the issue of system autonomy. In addition to providing a yes or no answer to the survey questions, many respondents provided additional comments.

In Table 1 of this Appendix, we present our survey questions and the number of responses to each. In Table 2, we present a summary of the answers to the independent budgetary, personnel, and procurement for each respondent. For this table, we took into consideration the comments provided by the system as well as the answer to the questions. Finally, in Table 3, we present individual system information pertaining to the board composition.

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TABLE 1 – Pennsylvania Department of the Auditor General Survey Questions and Total Responses to Each

Relationship with the Executive Branch		Yes	No	N/A
Is your system part of the executive branch of the state government?		19	9	0
Is your system required to receive approval from the Governor's Office or another executive agency to increase its number of staff?		13	7	8
Is your system required to receive approval from the Governor's Office or another executive agency to establish staff salaries?		15*	4*	8
Is your system required to receive approval from the Governor's Office or another executive agency to establish staff wages?		12*	6*	9
Does your system's legal staff fall under the jurisdiction of the legal department of the Governor's Office (i.e., the legal staff of the system reports directly or indirectly to the Governor's Chief Legal Counsel)?		5	15	8
	If Yes, does this mean that the legal department of the Governor's Office or another executive agency retains the authority to hire the legal staff that is supplied to your system?	5	0	23
	If Yes, does this mean that the legal department of the Governor's Office or another executive agency retains the authority to terminate the legal staff that is supplied to your system?	5	0	23
	If Yes, is your system required to receive approval from the Governor's Office or another executive agency to enter into a contractual agreement for the hiring of its own independent legal counsel?	5	0	23
Is your system required to receive approval from the Governor's Office or another executive agency for procuring supplies, equipment and services?		7*	12*	8
Is your system required to submit its annual budget through the Governor's office or another executive agency?		14	6	8
	If No, does your system have to receive annual budget approval from the Governor's Office or another executive agency?	0	15	13
	Is your system an independent agency wholly apart and autonomous from the executive branch?	8	19	1

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Budgetary, Personnel, and Procurement Independence		Yes	No	N/A
Does your system have absolute authority to increase its staff size?		12	14	2
Does your system have absolute authority to establish its staff salaries?		9*	16*	2
Does your system have absolute authority to establish its staff wages?		10*	15*	2
Does your system have absolute authority to hire its legal staff?		16	10	2
Does your system have absolute authority to terminate the services of its legal staff?		18	8	2
Does your system have absolute authority to procure its own supplies, equipment and services without any other necessary approval or a requirement that it abide by the statewide procurement rules?		9	17	2
	If No , is your system required to obtain approval from another state agency to procure supplies, equipment and services?	9*	7*	11
	If No , is your system required to abide by statewide procurement rules?	15	1	12
Is your system required to submit its annual budget to the state legislature?		19	7	2
	If No , does the state legislature have any authority over your system's budget?	1	6	21
Does the state legislature have any influence over your system's employee contribution rates?		22	4	2
Does the state legislature have any influence over your system's employer contribution rates?		18	7	3
System Board		yes	no	N/A
Does your system have a governing board?		29	1	1
How many members does the board have?		See Table 3, Governing Board Composition, for answers to these questions		
How many members, if any, serve by virtue of their office (ex-officio)?				
How many members, if any, are appointees of your state Governor?				
How many members, if any, are members of your state legislature?				

Legend:

- * One survey respondent did not clearly indicate a yes or no answer to the question.
N/A Survey respondent did not answer or question was not applicable to respondent.

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TABLE 2 – Survey Responses to Independent Authority Questions

Pension Fund	Independent Budgetary Authority	Independent Personnel Authority	Independent Procurement Authority
Pennsylvania Public School Employees Retirement System	No	No	No
Arkansas Public Employees Retirement System	No	No	No
California Teachers Retirement System ¹	Yes	Partial ^{2,3}	Yes
Colorado Public Employees Retirement Association ¹	Yes	Yes	Yes
Florida Retirement System	No	No	No
Georgia Employees Retirement System	No	No	Yes
Idaho Public Employee Retirement System	No	No	No
Indiana Public Employees Retirement Fund	No	Yes	No
Iowa Public Employees Retirement System ¹	No ²	No	Partial ⁴
Kansas Public Employees Retirement System	No	Partial ⁵	No
Louisiana State Employees Retirement System	No	Partial ⁶	Yes
Louisiana Teachers Retirement System	No	Partial ⁶	Yes
Maryland State Retirement and Pension System ¹	No	No	Partial ⁷
Massachusetts State Employees Retirement System	Yes	Yes	Yes
Massachusetts Teachers Retirement Board	No	Yes	No
Mississippi Public Employees Retirement System ¹	No	No ²	No ²

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Missouri State Employees Retirement System ¹	Yes	Yes	Yes
Nebraska Retirement System	No	No	No
Nevada Public Employees Retirement System ¹	No	Partial ⁸	No ²
New Mexico Public Employees Retirement Association	No	No	No
Ohio Public Employees Retirement System ¹	Yes	Yes	Yes
Ohio School Employees Retirement System	Yes	Yes	Yes
Ohio State Teachers Retirement System ¹	Yes	Partial ⁹	No ²
Oklahoma Public Employees Retirement System	No	No	No
Oregon Employees Retirement System ¹	No	No	No ²
South Dakota Retirement System	No	No	No
Texas Employees Retirement System	Yes	Yes	Yes
Wisconsin Retirement System	No	No	No
Wyoming Retirement System	No	No	No

Legend

- ¹ System participated in both the Independent Fiduciary Service survey and the Pennsylvania Department of the Auditor General survey.
- ² Independent Fiduciary Service survey results, as noted in its report, differ from the survey results obtained by Pennsylvania Department of the Auditor General.
- ³ The California State Teachers Retirement System is required to receive approval from the Governor's office or another executive agency to establish staff salaries and wages. It does have the authority to increase the number of staff.
- ⁴ The Iowa Public Employees Retirement System is required to abide by statewide procurement rules. It is not required to receive approval from the Governor's office or another executive agency to procure supplies, equipment, and services.

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-
- ⁵ Kansas Public Employees Retirement System is required to receive approval from the Governor's office or another executive agency to increase its number of staff and to establish salaries and wages for classified employees. It does have authority to establish the salaries and wages of unclassified employees and to hire/terminate legal staff.
 - ⁶ The Department of the Civil Service establishes the Louisiana State Employees and Teachers Retirement System employees' salaries, except for a small number of management personnel. The systems do have the authority to increase the number of staff and to hire/terminate their legal staff.
 - ⁷ The Maryland State Retirement and Pension Plan has authority to procure goods and services less than \$25,000. Any goods and service above \$25,000 must be approved by another executive agency. The system is subject to all state procurement laws and regulations.
 - ⁸ The Nevada Public Employees Retirement System does have authority to hire/terminate legal staff. The system does not have authority to increase its staff size or to establish salaries and wages. .
 - ⁹ The Ohio State Teachers Retirement System has authority to increase the number of staff and to establish salaries and wages. The system does not have authority to hire/terminate legal staff.

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TABLE 3 – Governing Board Composition

Pension System	Governing Board	Board Size	Ex-Officio Members	Appointed by Governor	State Legislature Members
Pennsylvania SERS	Yes	11	1	6	4
Arkansas PERS	Yes	9	3	6	0
California TRS	Yes	12	4	5	0
Colorado PERA	Yes	16	2	0	0
Florida RS	No	n/a	n/a	n/a	n/a
Georgia ERS	Yes	7	3	1	0
Idaho PERS	Yes	5	0	5	0
Indiana PER	Yes	5	0	5	0
Iowa PERS	Yes	11	1	6	4
Kansas PERS	Yes	9	1	4	0
Louisiana SERS	Yes	12	3	0	2
Louisiana TRS	Yes	16	4	0	2
Maryland SRPS	Yes	14	3	6	0
Massachusetts SERS	Yes	5	1	0	0
Massachusetts TRS	Yes	7	3	1	0
Mississippi PERS	Yes	10	1	1	0
Missouri SERS	Yes	11	2	2 ¹	4
Nebraska PERS	Yes	9	1	8	0
Nevada PERS	Yes	7	0	7	0
New Mexico PERA	Yes	12	2	0	0
Ohio PERS	Yes	11	1	1	1
Ohio SERS	Yes	9	0	1	0
Ohio STRS	Yes	11	1	1	1
Oklahoma PERS	Yes	13	3	5	0
Oregon PERS	Yes	5	0	5	0
South Dakota RS	Yes	17	1	2	0
Texas ERS	Yes	6	0	1	0
Wisconsin RS	Yes	13	2	2	1
Wyoming RS ²	Yes	11	1	10	0

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Legend

1. As a practical matter, it is three since one of the ex-officio members is the commissioner of administration, which is a governor-appointed position.
2. The Wyoming Retirement System did not include Board information in its survey responses. We obtained this information on June 5, 2006, from its website, <http://www.retirement.state.wy.us/ret1.htm>.

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Appendix B

IFS' Independent Fiduciary Review of the Pennsylvania State Employees' Retirement System, SERS

SERS Report I Department of the Auditor General Objectives

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Appendix B

IFS' Independent Fiduciary Review of the Pennsylvania State Employees' Retirement System, SERS

SERS Report I Department of the Auditor General Objectives



INDEPENDENT FIDUCIARY SERVICES, INC.

Independent Fiduciary Services, Inc.

**Investment Fiduciary Review
of the
Pennsylvania State Employees Retirement System**

**SERS Report I –
Pennsylvania Department of the Auditor General Objectives**

September 18, 2006

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Independent Fiduciary Services[®]

**Investment Fiduciary Review
of the
Pennsylvania State Employees Retirement System
SERS Report I**

Introduction

This Report is presented in four sections: an executive summary; background information and methodology; detailed discussion and analysis; and exhibits.

Section I, the Executive Summary, offers a high level overview of the major themes in the Report. The Executive Summary should be used in the context of the full Report.

Section II, Background and Methodology, describes Independent Fiduciary Services, Inc. (“IFS”) and the methodology we followed in performing this assignment. It then explains the overall format of this Report, within the context of the broader fiduciary review conducted by IFS and the audit conducted by the Pennsylvania Department of the Auditor General (“DAG”) and concludes with caveats and observations about the substantive sections of the Report.

The next Section III, Discussion and Analysis, comprises the body of the Report. Section III addresses all DAG Supporting Objectives (or tasks) defined in the April 14, 2005 Agreement for Investment Fiduciary Review Services.¹ The discussion and analysis of the objectives/tasks other than the DAG Supporting Objectives, i.e., the SERS Objectives is contained in a separate

¹ The objectives/tasks listed in Exhibit B under items A,G, I and M and the evaluation of the efficiency and effectiveness of class action activities (in Exhibit E) of the April 14, 2005 Agreement for Investment Fiduciary Review Service

report (“SERS Report II”). Since each report must be distinct, to facilitate readability, the task areas in this Report corresponding to DAG Supporting Objectives (Task Areas A, G, I, M, and Q listed in Exhibit B to the Agreement) are identified as I-A, I-B, I-C, I-D and I-E. The remaining objective/task areas listed in Exhibit B to the Agreement, addressed in SERS Report II are identified as II-A through II-M).

Section III sets forth background information (including best and common practices where applicable), detailed observed conditions and findings, and recommendations. Our findings and recommendations are based on the review we conducted of each objective/task area in coordination with the Board, the Executive Director, the Chief Investment Officer and the investment staff. Since each task area is addressed as a separate section, there is some overlap within the overall Report.

Section IV, Exhibits, contains supporting material, tables and charts that are referenced within the body of the report. However, many charts and tables are inserted in the body of the report where feasible. A summary of the report recommendations is provided as Exhibit F. Exhibit G contains the formal response of the DAG to IFS’ SERS Report I.

Section I.

Executive Summary

Basis for the Review

The Commonwealth of Pennsylvania State Employees' Retirement System (referenced interchangeably in this document as "SERS" or the "System") provides retirement, disability and survivor benefits for Pennsylvania state employees. SERS is governed by an eleven member Board. The Board determined that it was prudent and in the best interest of the Board and its numerous fund stakeholders and beneficiaries to have an independent, experienced financial services organization assist them in evaluating various aspects of SERS' operations and investment program.

SERS and PSERS (the Commonwealth of Pennsylvania Public School Employees' Retirement System) together issued RFP PSERS/SERS-2002-2, Request for Proposal for Fiduciary Audit Services, dated October 23, 2002. SERS and PSERS each selected Independent Fiduciary Services, Inc. ("IFS") to perform a fiduciary review relative to each of their investment organization and operations.

The Department of the Auditor General ("DAG"), SERS and PSERS entered into an Agreement for Investment Fiduciary Review Services, dated April 14, 2005 (the "Agreement"), which provides for fiduciary reviews of SERS and PSERS by IFS to complement the performance audits of SERS and PSERS simultaneously conducted by DAG. The IFS Objectives in support of the Auditor General's Performance Audit (the "DAG Supporting Objectives") addressed in this Report ("SERS Report I") consist of a review and evaluation of the following areas:

- Organizational structure and resources
- Due diligence procedures
- Legal matters
- Investment consultants' responsibilities
- Securities class action litigation activities

The remaining IFS objectives/task areas listed in Exhibit B to the Agreement and identified below (the "SERS Objectives") are addressed in SERS Report II:

- Investment policy
- Asset allocation
- Investment performance
- Investment performance reporting
- Performance benchmarks
- Costs and fees
- Investment personnel practices
- Investment manager structure
- Trust and custody arrangements
- Fiduciary liability insurance
- Innovative practices
- Proxy voting process
- Disaster preparedness.

IFS delivered the preliminary discussion documents concerning the DAG Supporting Objectives on November 14, 2005 and the SERS Objectives on December 14, 2005. Preliminary comments on the DAG Supporting Objectives were received from SERS on November 30, 2005. Comments were received from DAG on the DAG Supporting Objectives on December 13, 2005.

A face to face meeting with representatives from DAG and IFS to discuss DAG's comments was held on January 9, 2006. Written comments from DAG on the SERS Objectives were received on January 10, 2006. IFS provided written comments to DAG's comments on the preliminary drafts on January 19, 2006. Consistent with IFS' review methodology, as stated in Exhibit B of the Agreement, a first draft for review and discussion on the DAG Supporting Objectives and the SERS Objectives was submitted on January 19, 2006. Additional written comments were received from DAG during the month of March, 2006.² A face to face meeting was held with the SERS Chair and Executive Director on January 23, 2006. Written comments were received from SERS on March 3, 2006 and discussed with SERS on March 9, 2006.

In accordance with Amendment No. 2 to the Agreement, IFS submitted a second draft for review and discussion on April 14, 2006. SERS submitted their formal written comments on May 31, 2006 and DAG submitted their formal written response on June 14, 2006. SERS' comments were discussed on June 14, 2006 and DAG's comments were discussed on June 22 and 29, 2006. IFS presented the final draft report to the SERS Board on July 19, 2006 and received final Board comments on July 31, 2006. DAG provided its final formal written comments on August 25, 2006.

The following paragraphs describe in summary fashion some of the highlights of our Report. IFS has performed numerous operational reviews of public pension funds over the past twenty years. The results of this review demonstrate that, except with respect to its current degree of autonomy, SERS is in line with best practices in terms of its overall governance, administration and management of its investment program. We thank the Board members for their time during this project. We also thank Mr. Henry and his staff for all of their time and cooperation during our review. We especially thank Mr. Knepp for coordinating the project and seeing to our needs and numerous requests for information.

² March 3rd, 13th, 15th and 16th.

Key Findings and Recommendations Regarding DAG Objectives

I-A. Organizational Structure and Resources

The SERS governance structure includes several features which give the Governor significant and atypical control over the System. These features include the Governor's appointment, subject to Senate confirmation, of a majority of the Board, with no legislated criteria regarding the qualifications of the appointees; the absence of Board members nominated or elected by the SERS membership; and the Governor's power to designate the Board's Chairman. In addition, as discussed below, the System's legal counsel is a Chief Counsel designated by the General Counsel, who is appointed by the Governor. While IFS is fully aware of the difficulties and risks associated with the legislative process, IFS has recommended that SERS support and, if enacted, implement legislation intended to modify SERS governance structure. This legislation should grant to the SERS Board a level of autonomy appropriate in view of the SERS Board's fiduciary responsibilities of prudence and loyalty to the interests of the SERS membership imposed by Commonwealth law. These suggestions include:

- Giving the Board the power to elect its Chairperson
- Providing for nominations by the SERS membership (or organizations representing the membership) for Board positions appointed by the Governor.
- Requiring at least one of the Governor's appointees has investment expertise.

SERS has adopted a succinct but impressive Mission Statement, which provides, "The mission of SERS is to provide retirement benefits and services to our members through sound administration and prudent investments." The Mission Statement's seven Guiding Principles address the key issues appropriate to a public retirement board. SERS other governing

documents, i.e. the Bylaws and Statement of Investment Policy are also well-crafted, but we recommend that the Board develop and adopt a formal Statement of Governance Principles and that the Board consider delegating to qualified staff authority to make certain investment decisions related to private equity, real estate and alternative investments, subject to guidelines established by the Board, with appropriate reporting requirements to the full Board or an appropriate Committee. IFS also believes that the Board should consider establishing committees in the areas of investment, budget and technology to provide a structure to evaluate recommendations received from staff and consultants.

SERS has no dedicated “middle office” function. The middle office function sits between the “front office” (investment management and trading) and “back office” (clearance, settlement, accounting, and reporting). A middle office that is independent of portfolio management provides a means of independent review. As an example, the middle office can be responsible for monitoring aspects of investment performance and risk measurement, trading compliance and attribution analysis for performance measurement (rather than for portfolio management). We believe that the middle office structure described in our Report would be valuable to SERS and that the general notion of maintaining a middle office provides enhanced internal control and appears to be a sound evolution of the SERS Audit Reporting and Compliance (ARC) group.

I-B. Due Diligence Procedures

While our overall conclusion in this area is that SERS due diligence procedures are thorough and well documented, we believe that given the sophisticated investment strategies in which the System invests, SERS could enhance its monitoring methodologies. New and innovative investment strategies create challenges when it comes to monitoring and measuring risk and the Board should reconsider whether it would benefit from receiving more detail on the risks incurred by the investment program.

I-C. Legal Matters

By law, SERS now receives legal advice from its Chief Counsel, who is appointed by the Commonwealth General Counsel, an appointee of the Governor. All SERS contracts must be approved not only by the Chief Counsel, but also by both the General Counsel and the Attorney General. As mentioned above, IFS is fully aware of the difficulties and risks associated with the legislative process; however, IFS believes that the SERS Board should have access to legal counsel with unconflicted loyalty to SERS and should seek legal authority to hire a staff attorney who would be appointed by and serve at the pleasure of the Board. While the current structure remains in place, the Board and General Counsel should negotiate a formal Memorandum of Understanding establishing a process for dealing with conflicts if and when they arise. Additionally, the contracting process could be made more efficient by exempting SERS from the requirement to obtain approval of all contracts from the Attorney General and the General Counsel.

Pennsylvania law articulates an appropriately rigorous standard of fiduciary responsibility applicable to the Board members and appropriate staff and outside service providers (though we perceive a need for greater clarity as to Board members' designees). Another positive aspect of the legal framework is the absence of "legal lists" or other legislated constraints on the Board's investment discretion (other than the fiduciary standard).

Certain other statutory requirements render crucial aspects of SERS' administration subject to the control of other branches of government who are not subject to the same rigorous standard of fiduciary responsibility as are the members of the SERS Board. That fiduciary standard renders pension fund boards different from other state agencies. Because evolving standards of public pension fund governance favor granting to fund boards substantial autonomy so long as they are subject to a rigorous standard of conduct, IFS has recommended enhancements to the Board's autonomy, including:

- Power to establish SERS' administrative budget, to be paid from the SERS assets (as opposed to the Commonwealth's general revenue), subject to the same standards of prudence and loyalty applicable to other aspects of the System's management.
- Authority to establish and operate personnel and procurement policies.

In addition, typically, best practice for selecting, contracting with and retaining a global custodian is to give full authority to the System's board and staff, even when the state treasurer is the statutory custodian. In Pennsylvania, the State Treasurer not only has the statutory custodial role but has operational authority to contract with a bank on behalf of SERS and other entities. Uniquely, this has led to a current arrangement that is particularly advantageous to the Commonwealth and the bank. The Treasurer has selected one of the top tier global custody banks and entered into a fixed fee contract for not only the two primary pension systems (SERS and PSERS), but including a number of smaller governmental entities. The bank enjoys holding the entire pool of assets and the investing systems enjoy an attractive price for quality service. The risk in the current arrangement is that the current or a future Treasurer can decide unilaterally to move the custody to a less qualified provider, a costly and time-consuming process. While we believe that ultimately the Board should have authority to select and contract with the custody bank, up until the time that is the case the Board and the Treasurer should establish a mechanism whereby the SERS Board and staff can provide meaningful input into the process.

In the area of ethics, IFS found that several overlapping statutes apply to the members of the Board, depending on whether they are legislative members of the Board, the Treasurer or the Governor's appointees. Some of the differences are significant, such as the rules governing gifts to Board members. IFS has recommended that a single set of standards apply to all the members of the Board. In addition, IFS has recommended that the Board implement "pay to play" rules to bar current and prospective service providers from making political contributions to Board members or the officials who appoint them. The Board should also adopt a recusal policy. IFS

also observed that while Board members are properly subject to a detailed set of procedures for obtaining reimbursement of expenses, few Board members attend educational conferences for public fund trustees which are held outside of Pennsylvania. The Board has not adopted a formal travel policy to govern such activity, and IFS recommends that the Board do so in order to provide opportunities for Board members to obtain appropriate training and education while mitigating both the appearance and the reality of any abuses.

I-D. Investment Consultants' Responsibilities

SERS use of three investment consultants (a generalist, a real estate specialist and an alternatives specialist) is in line with best practices and we found that all three firms are providing satisfactory and high quality services.

I-E. Securities Class Action Litigation Activities

Best practices in this area call for boards of trustees to adopt a formal securities litigation policy. Prior to May 24, 2006, SERS implemented its securities litigation program through a series of documents, commencing with SERS Resolution 2003-49. IFS reviewed, commented upon and made recommendations concerning the procedures described in these documents and we recommended that SERS develop and adopt a formal, comprehensive securities litigation policy. We outlined the contours of such a policy and included recommended provisions in our Report.

Prior to finalization of this Report, SERS' General Counsel provided IFS with a copy of a new Securities Litigation Policy, which was approved by the SERS Board on May 24, 2006, after the date of our review (June 30, 2005). Based on a preliminary review of the new Policy, however, it appears that SERS has addressed many of the concerns IFS raised in its initial review of the System's securities litigation program.

Section II.

Background, Review Methodology, and Limitations on the Report

IFS specializes in evaluating the organizational governance, day to day administration, and investment programs of pension systems using combined expertise in investment practices, pension fund administration and fiduciary responsibility. In operation for almost 20 years, IFS has performed similar evaluations for numerous other public and private pension funds, and is recognized as the leading firm in the industry performing this type of consulting services.

The specific details, scope and depth of the review are defined by the April 14, 2005 Agreement, among SERS, PSERS, DAG and IFS.

Throughout the Report, as part of our fiduciary review methodology, we identify and highlight our findings or observations and provide recommendations. As part of this process, we set forth and explain the principles and criteria we use for the scope area being evaluated. Our goal is not only to identify problems, it is to “add value” by identifying alternatives intended to enhance the pension fund’s operations and/or address prospective problematic issues. For this reason, the initial standard we typically use in making our findings and recommendations is industry “best practice.” A “best practice” is not necessarily the “norm” or most common practice, rather it is the most effective and efficient means (e.g., a process, procedure or structure) of doing something in a given situation to achieve an optimal outcome. Since effectiveness and efficiency are situational, what is a best practice for one operation may not be a best practice for all operations.

A best practice is often viewed as the baseline, the experience-tested optimum standard, which is then modified to suit a particular organization. What is a “best practice” for an

individual organization is determined by examining how a particular function is carried out and then concluding what course of action/methodology would enhance the process. To appreciate the importance of “best practices” it is essential to recognize the difference between a function being achieved and a function being achieved in an effective and efficient manner – the distinction is analogous to the differentiation between being good and being great. IFS’ declaration of a “best practice” is based on a combination of various legal standards (enacted and proposed) – e.g., ERISA³, UPIA⁴, UMPERSA,⁵ secondary research from authoritative industry sources (e.g., studies and pronouncements by DOL, SEC, and industry professional organizations), its own empirical assessments of pension fund practices attained performing similar fiduciary reviews, and the extensive experience of the firm’s staff, many of whom, having worked at pension funds have first-hand knowledge of the nuances of pension fund processes.

Our approach also recognizes that it is difficult to transform the status quo without an apparent problem. A pension fund may not have the inclination or statutory ability to bring its operations in line with best practices. For this reason, we attempt to also include alternative recommendations, where feasible, which take into consideration the practical realities of the

³ The Employee Retirement Income Security Act of 1974 (ERISA) is a federal law that sets minimum standards for most voluntarily established pension and health plans in private industry to provide protection for individuals in these plans.

⁴ The Uniform Prudent Investor Act (UPIA) was promulgated by the National Conference of Commissioners on Uniform State Laws (the “Uniform Law Commissioners”) in 1994. The Prefatory Note to UPIA states that the model law “undertakes to update trust investment law in recognition of the alterations that have occurred in investment practice.” UPIA was endorsed by the American Bar Association and has been adopted in 46 states.

⁵ The Uniform Management of Public Employees Retirement Systems Act (UMPERSA) was promulgated in 1997 by the Uniform Law Commissioners to provide legal rules that would permit public employee retirement systems to invest their funds in the most productive and secure manner, with a minimum of regulatory interference. UMPERSA modernizes, clarifies, and makes uniform the rules governing the investment and management of public retirement systems’ assets. UMPERSA was endorsed by the American Bar Association. A number of public pension fund organizations participated in the development of the law (e.g., the National Council of Public Employees Retirement Systems (NCPERS) the National Council on Teacher Retirement (NCTR), and various members of the National Association of Public Pension Attorneys (NAPPA). However, because UMPERSA did not address portability, pension board representation, full funding, service credit purchase, disclosure and reporting proxy voting, contractual rights to benefits, and domestic relations orders, it was not endorsed by the public pension fund organizations that participated in its development.

pension fund's circumstances and functional environment. We note these situations in the text of the report.

The analysis leading up to this Report progressed through the following stages:

Document Collection

The first stage in our process was collection – with the staff's cooperation – of information regarding the Board's investment program, practices and operations. This included amassing extensive data and documents, such as the Board's enabling and related statutes, written operating policies and procedures governing the organization, written investment policies and guidelines, service provider contracts, and other materials. This phase was conducted primarily in May and June, 2005, with additional documents requested as necessary. DAG also received all of the documents we requested.

Analysis

The next stage of our process, which continued throughout the project, was analysis. In undertaking this review, IFS employed a team approach, assigning certain of its personnel to concentrate on particular subject areas. Throughout the process, we coordinated and integrated our efforts and maintained communication with representatives of the Board.

Interviews & Discussions

The third stage of the process was to hold a series of interviews with people directly associated with the Board. These included face-to-face and/or telephone interviews with the Board Members, the Executive Director, investment staff members, legal counsel and various service providers. The main interview phase was conducted in two phases in June and July, 2005. Subsequent interviews were conducted in person in Philadelphia or Harrisburg and by

telephone. Representatives from DAG attended all of our staff, Board and service provider interviews.

Survey and Research

IFS developed a lengthy survey directed at peer public pension funds. We developed a list of peer funds (the “custom peer group”), which was approved by SERS, based on certain factors. Experts will acknowledge that no two pension funds are precisely identical. Some argue the various differences among the pension funds cancel each other out and therefore asset size is the appropriate measure of comparability. The distinctions among pension funds are many. However, some have more factors in common than others. Therefore, we use commonality of characteristics to measure comparability. The greater the number of shared characteristic, the greater the level of comparability.

We define the SERS “peer group” as the pension funds with the greatest level of comparability to SERS. To determine comparability and define the SERS “custom peer group, we considered not only the size of the fund (e.g., assets under management), but also the complexity of the investment portfolio (e.g., the extent of participation in various asset classes, whether the majority of assets were internally or externally managed, the use of active versus passive management of investment assets, whether the entity was responsible for investments and benefits administration, etc. Based on the comparability characteristics, IFS identified sixteen funds as suitable for participation in the survey pool. Outliers (funds that mirrored SERS less than some) were also included to assess whether their diminished comparability had a significant impact on the comparison. (See Exhibit A – Custom SERS Peer Group Survey Recipients) Using commonality of characteristics IFS would typically not consider SERS’ sister fund (PSERS) as a peer. However, we agreed to include PSERS because there is an instinctive comparative tendency with respect to “sister funds.”

Ten funds responded, including PSERS (see Exhibit B - Custom SERS Peer Group Respondents), although several funds did not provide all of the information requested. Several recipients declined to participate due to the significant amount of time required to compile the necessary information to respond to the survey. To promote participation we agreed, if requested, to maintain the confidentiality of information and to provide participants with a copy of the survey results. Where confidentiality is a consideration we do not attribute such information to a specific organization. Rather when reviewing such information each survey participant was assigned a code letter.

The results of the survey are incorporated throughout the Discussion and Analysis section of the report where applicable. We can not attest to the accuracy of the data provided by the peer funds. A copy of the survey instrument used can be found at Exhibit C.

In addition to the survey, we also researched the enabling statutes, regulations and governance documents of the peer group members to obtain information that was not requested in the survey or where clarification was needed.

Draft, Preliminary, and Final Report

The written report also progressed through several stages. IFS delivered the preliminary discussion documents concerning the DAG Supporting Objectives on November 14, 2005 and the SERS Objectives on December 14, 2005. Preliminary comments on the DAG Supporting Objectives were received from SERS on November 30, 2005. Comments were received from DAG on the DAG Supporting Objectives on December 13, 2005. A face to face meeting with representatives from DAG and IFS to discuss DAG's comments was held on January 9, 2006. Written comments from DAG on the SERS Objectives were received on January 10, 2006. IFS provided written comments to DAG's comments on the preliminary drafts on January 19th 2006. Consistent with IFS' review methodology, as stated in Exhibit B to the Agreement, IFS submitted a first draft for review and discussion on the DAG Supporting Objectives and the

SERS Objectives on January 19, 2006. Additional written comments were received from DAG during the month of March, 2006.⁶ A face to face meeting was held with the SERS Chair and Executive Director on January 23, 2006. Written comments were received from SERS on March 3, 2006 and discussed with SERS on March 9, 2006.

In accordance with Amendment No. 2 to the Agreement, IFS submitted a second draft for review and discussion on April 14, 2006. SERS submitted their formal written comments on May 31, 2006 and DAG submitted their formal written response on June 14, 2006. SERS' comments were discussed on June 14, 2006 and DAG's comments were discussed on June 22 and 29, 2006. IFS presented the final draft report to the SERS Board on July 19, 2006 and received final Board comments on July 31, 2006. DAG provided its final formal written comments on August 25, 2006.

This process of draft, comment and redraft enabled relevant parties to point out matters that, in their view, were either factually or conceptually inaccurate, incomplete or misleading, and enabled us to obtain additional information and prepare a revised draft and subsequently a final report that takes into account all relevant comments. The final product reflects the combined analytical and writing efforts of a diverse team of investment professionals. To the extent IFS did not agree with the comments of SERS or DAG and the language in question was not added or changed, such comment(s) are included in this Report. SERS responded to each of IFS' recommendations and their responses are noted in the body of the Report. DAG prepared a letter response to the Report (Exhibit G) and we refer the reader to their response where appropriate. It is important to note that the fiduciary review methodology and drafting process differs and is not intended to be analogous to the general audit process.

⁶ March 3rd, 13th, 15th and 16th.

Report Caveats

This Report should be read and evaluated with the following caveats in mind.

- First, many of the subjects addressed in this Report are inherently judgmental and not susceptible to absolute or definitive conclusions. Many of our conclusions constitute alternatives for the Board and staff to consider in light of SERS' evolving investment program, management and practices now and over the coming years.
- Second, in conducting this review, we assumed the information we were provided, whether by the Service Providers, SERS or the custom peer funds, is accurate, and could be relied upon, including the information presented in response to the survey. We can not attest to the accuracy of the data provided by the survey peer group respondents. We sought to cross-verify certain information among different interviewees, survey respondents and documents, but the process of cross-verification was limited.

We were not hired to detect or investigate fraud, concealment or misrepresentations and did not attempt to do so. We were not hired to, and did not attempt to conduct a formal or legal investigation or otherwise to use judicial processes or evidentiary safeguards in conducting our review. Our findings and conclusions are based upon our extensive review of documents, the interviews we conducted with the Board, staff, and others associated with SERS, independent analysis, and our experience and expertise.

- Third, this Report does not and is not intended to provide legal advice. Although the report considers various legal matters, IFS' analysis, findings and recommendations are not intended to provide legal interpretations, legal

conclusions or legal advice. For that reason, action upon such matters should not be taken without obtaining legal advice addressing the appropriate statutory or regulatory interpretation and legal findings regarding such matters.

- Fourth, our observations are necessarily based only on the information we considered as of and during the period we performed our review, especially as of June 30, 2005 for the investment holdings.
- Fifth, our Report cannot and does not attempt either to assess the manner in which any of our recommendations may be implemented or observed in the future, or predict whether SERS' practices, as represented to us, will be observed in the future. Nor does our Report supplant or reduce the ongoing independent fiduciary duty of the Board and staff to structure and evaluate their investment program or policies and procedures.
- Sixth, although this Report sets forth observations and recommendations regarding SERS' internal controls, we did not conduct – or attempt to conduct – a full or formal examination of SERS' internal control system. This Report is not intended as a substitute for such an examination, if one is appropriate. The scope of our work was limited by our contract with the Board.
- Finally, although we have discussed our findings with, and submitted draft versions of our Report to SERS and to DAG, its final form and content reflect the independent judgment of IFS. The extent to which our Report and recommendations are implemented is the Board's decision.

Please see DAG's response at Exhibit G for comments on this section.

Section III.

Discussion and Analysis

I-A. Organizational Structure and Resources

1. BACKGROUND

The organizational and management structures and processes utilized by an organization for decision-making, implementing its decisions, and for monitoring and assessing performance define its governance. An organization with good governance has structures and processes which enhance the organization's efficiency and effectiveness while minimizing both the potential and the impact of mismanagement. A good governance structure is generally composed of the following principal elements: adherence to law and rules; accountability; predictability; participation; consensus; transparency; responsiveness; inclusiveness; equity; effectiveness and efficiency. These principal elements are necessary to the governance of all types of organizations, including public pension plans and remain the same irrespective of the type or size of a pension plan.

Good governance adds value. It has been documented that the value of poorly performing companies improved significantly after the institution of good governance practices.⁷ We believe the same is true for public pension funds. The need for good public pension fund

⁷ Wilshire studies of "CALPERS effect." Steven L. Nesbitt, Long-Term Rewards From Shareholder Activism: A Study of the "CalPERS Effect", J. of Applied Corp. Fin. (Winter 1994). and Steven L. Nesbitt, The "CalPERS Effect": A Corporate Governance Update, July 19, 1995. The 1994 and 1995 studies were more extensive and supported Wilshire's initial 1992 study indicating that a company's stock performance seemed to improve as a result of CalPERS' focus.

governance arises from the same types of issues that give rise to the need for good corporate governance.

Poor governance is an internal threat that can unnecessarily expose a pension fund to the possibility that policies and procedures may not be implemented properly and that the assets under the authority and control of the Board will underperform expectations.⁸ Poor governance is typically ranked as the principal barrier to excellence within an organization, followed by inadequate resources and lack of focus or of a clear mission.⁹

In an organization with numerous interrelated parties responsible for various interrelated functions, a clear delineation of their various roles, lines of authority and reporting responsibilities could assist the organization in effectively and efficiently achieving their objectives.

The Development and Use of Governance Documents Is Consistent with “Best Practice”

Set forth below are some of the essential documents that define a pension fund’s organizational and management structures and processes:

- **A Mission Statement**
- **A Strategic Plan** – a document that summarizes the fund’s short and long-term goals and objectives. It defines where an organization is going, how it is going to get there, and how it will know if it got there or not.
- **Bylaws**

⁸ Public Pension Systems Statements of Key Risks and Common Practices to Address Those Risks, July 2000. Endorsed by the Association of Public Pension Fund Auditors (APPFA), the National Association of State Retirement Administrators (NASRA), and the National Council of Teachers Retirement (NCTR).

⁹ Source: “Excellence Shortfall in Pension Fund Management: Anatomy of a Problem” by Keith Ambachtsheer, Craig Boice, Don Ezra and John McLaughlin – October 1995.

- **Resolutions (Actions on Motions)** – documenting the decisions of the Board members
- **Minutes** – recording the proceedings at the Board’s formal meetings
- **A Governance Statement** – a document that clearly defines the appropriate roles, responsibilities and permissible conduct of the “key players.” It should describe who has authority over whom and who is responsible for what and when.
- **An Investment Policy Statement and Investment Guidelines** – documents that define and clarify the Board members’ investment objectives, tolerance for risk, liquidity needs and permissible (impermissible) investment strategies, asset classes, and instruments.
- **A Standard Operating Manual** – a compilation of the organization’s policies, procedures, and practices, as well as functional position descriptions of the organization’s staff.
- **An educational policy** – a policy setting forth processes for Board members and key staff to obtain access to programs providing information about developments related to investment of pension fund assets
- **A well-defined ethics policy**
- **A committee structure** with “charters” defining their roles and responsibilities

Our examination of SERS’ organizational and management structures – governance – focused on the appropriateness of the governance documentation, identifying ways in which the roles and procedures of the various parties work effectively or pose problems, the sufficiency of the nature and functions of the various committees utilized by SERS, and comparing the stated duties and procedures of each Committee against the actual performance. We also look at the organizational resources of the Board, including specifically information technology. In addition, we discuss one important element of governance within an organization such as SERS, the internal audit function.

2. Board and Committees

While in a few jurisdictions a sole trustee (sole fiduciary) has authority over the assets of public pension funds, the more typical model is the establishment of a board of trustees to carry out that function.¹⁰ The SERS Board was established and is governed by the SERS Retirement Code, Title 71 of the Pennsylvania Consolidated Statutes. Section 5901(a) of the Retirement Code states, “The board shall be an independent administrative board,” and Sections 5901 and 5902 grant specific powers to and impose duties on the Board, including:

- Power to contract for services of professionals¹¹
- Power to pay expenses from the fund’s investment earnings provided they are approved by the General Assembly
- Duty to maintain records available for public inspection
- Duty to hold at least six regular meetings per year
- Duty to adopt rules and regulations “for the uniform administration of the system”
- Duty to adopt actuarial tables

¹⁰ Exhibit D lists the 12 peer group systems governed by a board of trustees. The Connecticut Retirement Systems and the New York State Common Fund are examples of state-wide pension systems governed by a single trustee (the State Treasurer in Connecticut and the State Comptroller in New York). That said, each sole trustee has an advisory board: the New York State Advisory Board provides input on investments, benefits, governance and actuarial issues; and the Connecticut Investment Advisory Council’s has an oversight role which includes, among other things approval of the asset allocation plan establishing an investment framework within which the sole trustee functions.

¹¹ The statute’s list of professionals the board may contract with notably excludes legal counsel.

- Duty to publish annual financial statement of the System
- Duty to provide for an annual audit by an independent certified public accountant

In addition, and of particular relevance to this report, is the Retirement Code's grant to the Board of "exclusive control and management of the [SERS] fund and full power to invest same...."¹²

a. Board Structure

The SERS Board consists of 11 members, as follows:

- The State Treasurer, *ex-officio*
- One majority and one minority member of the Senate, designated by the President Pro Tem
- One majority and one minority member of the House of Representatives, designated by the Speaker
- Six persons appointed by the Governor, with the advice and consent of the Senate; one of the appointees must be a SERS retiree

At least five of the Board members must be members of the System (i.e., employees of the State or independent agencies for whom the System provides retirement benefits), and at least two must have earned at least 10 years of credited service to be counted toward determining eligibility for benefits and the amount of benefits they may receive from the System.¹³ While the Retirement Code expressly permits only the four legislative members of the Board to appoint

¹² The State Employees' Retirement Code, 71 P.S. § 5101 *et seq.* ("Retirement Code") Sec. 5931(a).

¹³ The SERS Member Handbook explains eligibility for membership in the System and the rules for determining credited service.

designees “to serve in their stead,”¹⁴ the SERS Bylaws also permit the Board’s sole ex-officio member, the State Treasurer, to appoint designees.¹⁵ In addition, while the Bylaws allow the legislative and ex-officio members to name multiple designees, the documents made available to IFS indicate that each has named only one designee.¹⁶

SERS is governed by a slightly larger than average Board. To support this conclusion, in Table I-A-1 we examine the composition of 28 boards¹⁷ including SERS’ and PERS’ customized peer group and the Teachers Retirement System of Texas. Three of the funds in the sample group – the Missouri Public Employees Retirement System (MOSERS), the Teachers Retirement System of Texas, and the California State Teachers Retirement System were finalists for the Savviest Plan Award.¹⁸ MOSERS won the award.

The median board size among the sample group reviewed is 9.5.¹⁹ Five members of the sample group also have eleven member Boards. Six have larger boards (SERS’ sister fund – PERS; Maryland State Retirement System; Colorado Public Employees, and California State Teachers, North Carolina (which has two boards)). In a larger survey of 50 pension funds, conducted by IFS in 2000 to assist the Governor’s Task Force on Iowa Public Employees Retirement System Structure and Governance, the median board size was seven, with a range of five to 17 members. Our interviews with Board and staff members, as well as our own analysis and observation of the Board’s decision-making process did not indicate that that the slightly larger than median size of the Board rendered its decision-making process inefficient.

¹⁴ Retirement Code Sec. 5901(a). This is in contrast to the Board of the Pennsylvania School Employees’ Retirement System, where seven of the 15 Board members, nearly a majority, can act by designees.

¹⁵ SERS Bylaws Sec. 1.4.

¹⁶ *Ibid.* The SERS Board members’ practice of naming only one designee significantly distinguishes the SERS Board’s practice in this area from the Board of the Public School Employees’ Retirement System, where seven members of the Board can appoint designees, and several of those Board members appoint multiple designees, any one of whom can and does appear at meetings of the PSERS Board.

¹⁷ Both boards for LACERA and Oregon were considered.

¹⁸ Awarded by Money Letter, a publication of Institutional Investor Inc., in their 5th Annual Public Fund Award program.

¹⁹ For the funds with a Sole Trustee, Connecticut and Michigan, we reviewed the Investment Advisory Boards that provide investment advice to the State Treasurer.

***A Majority of the SERS Board is Appointed by the Governor
and No Board Members are Selected
by the SERS Members***

The composition of the SERS Board has several uncommon features. A majority of the SERS Board is appointed by the Governor, and the Retirement Code imposes no criteria on the Governor's appointees other than the fact that one of the six appointees must be a SERS retiree.²⁰

The governor appoints some number of board members on all but four of the state funds included in Table I-A-1. In fact, in Arizona, Nevada, and at Texas Teachers the governor appoints all the members of the Board. Nevertheless, with the exception of Oregon, whether the governor appoints all or a majority of the board members (Iowa, North Carolina, Virginia, and Wisconsin) the governor is required to include appointees which represent the membership of the fund. Further, as reflected in the footnotes to Table I-A-1, a significant number of the boards listed also have a requirement that some number of the board members must have specific expertise (e.g., Iowa, Virginia, SWIB, Arizona, New York State Teachers, Ohio, Oregon and Texas Teachers).

A second unusual feature is that none of the members of the Board are elected or nominated by the members of SERS. At a majority of SERS' customized peer group, as well as SERS' sister fund PSERS, some number of board members are elected by the membership. At some funds even where the Governor appoints the members it is from a slate provided by the members. (See Table I-A-1 and Exhibit D.)²¹

A third uncharacteristic feature is that the Retirement Code requires that the Governor, not the Board, select the Board's Chairman.²² As Table I-A-1 reflects, this feature is not

²⁰ The requirement that five Board members be members of SERS can be satisfied by the legislative appointees and the Treasurer.

²¹ An explanation of how the peers group was constructed is provided in the Introduction to this Report.

²² Retirement Code Sec. 5901(a).

commonly found. Typically the members of the board elect their Chair. The governor appoints the Chair at only three pension fund entities examined in Table I-A-1 – the Virginia Retirement System, the Texas Teachers System and the Connecticut Investment Advisory Council. While the Chairman only has one vote, the SERS Bylaws give the Board’s Chairman key influential duties. The Chairman establishes the Board’s agenda,²³ can call special and emergency meetings²⁴ and can establish special advisory or review committees (including committees that review and score responses to requests for proposals to provide services to the Board)²⁵ and appoints committee members (unless the Board resolves otherwise).²⁶ The Chair serves as the Board’s primary link with SERS’ Executive Director and Chief Investment Officer to carry out the Board’s policies and directives. The current Chairman of the SERS Board has served in that capacity for approximately 13 years.

TABLE I-A-1 – REVIEW OF BOARD SIZE, MEMBER REPRESENTATION GOVERNOR’S APPOINTMENT AUTHORITY AND TERM OF CHAIR					
PENSION FUND	BOARD SIZE	MEMBERS APPOINTED BY THE GOVERNOR	GOVERNOR DESIGNATES CHAIRMAN?	CHAIR’S TERM	Member Representation of the Board
Public School Employees Retirement System of PA	15	2	No – Chair elected by Board ²⁷	Annual	Yes
State of Connecticut Trust Funds	Treasurer is Sole trustee	5 - IAC See note ²⁸	IAC Chair appointed by Governor		<i>Yes on the Advisory Board</i>
Illinois TRS	11	4	NO- Statutory Designee ²⁹	<i>Term of the statutory designee</i>	Yes

²³ Bylaws Sec. 2.2.

²⁴ *Id.*, Secs. 2.3 and 2.4.

²⁵ *Id.* Art. III

²⁶ *Ibid.*

²⁷ Chair and Vice Chair are elected by the Board annually. (Retirement Code Sec. 8501(a); Bylaws §§ 3.1 and 3.2.)

²⁸ The Treasurer, as sole trustee, develops investment policy and hires investment managers with the approval of the Investment Advisory Committee (IAC). The membership of the IAC consists of the Secretary of the Office of Policy and Management (ex-officio), State Treasurer (ex-officio), five public members to be appointed by the Governor and legislative leadership, all of whom shall be experienced in matters relating to investments, three representatives of the teachers’ unions and two representatives of the state employees’ unions.

²⁹ The president (Chairman) of the Board of Trustees, by law, is the Illinois superintendent of education. The Board of Trustees elects its vice president from among its members.

TABLE I-A-1 – REVIEW OF BOARD SIZE, MEMBER REPRESENTATION GOVERNOR'S APPOINTMENT AUTHORITY AND TERM OF CHAIR					
PENSION FUND	BOARD SIZE	MEMBERS APPOINTED BY THE GOVERNOR	GOVERNOR DESIGNATES CHAIRMAN?	CHAIR'S TERM	Member Representation of the Board
Iowa PERS	11 ³⁰	6 ³¹	No – Chair elected by voting members of Board ³²	Annual	Yes
LACERA (has two boards – BOR & BOI)	9 ^{33/9}	N/A	Municipal board – Chair elected by board members	Annual	Yes
Md. State Retirement and Pension System	14 ³⁴	5	No – Chair elected by Board ³⁵	Annual	Yes
Mass PRIM	9	2	Treasurer is statutory Chair	Term of the statutory designee	Yes
Minnesota State Board of Investment	4 ³⁶	0	Governor is the Chair	Term of the statutory designee	No
Mississippi PERS	10 ³⁷	1	No – elected by Board ³⁸	-	Yes1

³⁰ There is an Investment Board (11 members, seven voting and four non-voting) and a Benefit Advisory Committee (9 voting and 2 non-voting)). The Investment Board members are designated as the trustees of the retirement fund.

³¹ Iowa Code § 97B.8 provides that the six gubernatorial appointments of the Investment Committee are as follows: an executive of a domestic life insurance company, an executive of a state or national bank operating within the state of Iowa, an executive of an industrial corporation located within the state of Iowa, and three members of IPERS, one of whom is an active member who is an employee of a school district, area education agency, or merged area, one of whom is an active member who is not an employee of a school district, area education agency, or merged area, and one of whom is a retired member of the system. The gubernatorial appointments are subject to confirmation by the senate.

³² Iowa Administrative Code - §495—2.1(97B) – at the first meeting in each fiscal year, the voting members shall elect a chair and vice chair.

³³ Retirement Board has 9 member and two alternates. The Investment Board has 9 members.

³⁴ Maryland Code - §21-104.

³⁵ Maryland Code - §21-105.

³⁶ Comprised of the Governor, the State Auditor, the Secretary of State, and the Attorney General.

³⁷ Membership of the Board is set forth in Miss. Code Ann. §25-11-15 (1972, as amended), and consists of the following ten (10) representatives: the state treasurer, one representative who is a member of the System and who is appointed by the Governor; two members elected by state employees; one member elected by county employees; one member elected by municipal employees, one member elected by employees of the Institutions of Higher Learning; two retirees elected by retired members, and one member elected by employees of the public schools and employees of the public community colleges. Each member fills a term as specified in the statute, generally a six year term unless the member serves ex officio or is appointed.

³⁸ §25-11-15(9)

TABLE I-A-1 – REVIEW OF BOARD SIZE, MEMBER REPRESENTATION GOVERNOR'S APPOINTMENT AUTHORITY AND TERM OF CHAIR					
PENSION FUND	BOARD SIZE	MEMBERS APPOINTED BY THE GOVERNOR	GOVERNOR DESIGNATES CHAIRMAN?	CHAIR'S TERM	Member Representation of the Board
Missouri Public School	7	3	No – elected by Board	Annual	
MOSERS	11	2 ³⁹	No – Chair and Vice Chair elected by the Board ⁴⁰	Annual – limited to two consecutive terms	Yes
Nevada Public Employees	7	7 ⁴¹	No – Chair elected by Board ⁴²	Annual	Yes
Virginia Retirement System	9	5 ⁴³	Yes ⁴⁴	Two years not to exceed two consecutive terms.	No
State of Wisconsin Investment Board	9 ⁴⁵	6 ⁴⁶	no – Elected by the Board	Annual	Yes
Wash. State Investment Board.	10 ⁴⁷	3 ⁴⁸	No – Chair elected by Board	Annual	Yes

³⁹ Missouri Code - § 104.450.

⁴⁰ 104.460. 1. The board shall elect by secret ballot one member as chairman and one member as vice chairman during the first board meeting of each year.

⁴¹ Three must be active members of the System nominated by employee groups, two must be nominated by contributing employers; one must be an agency manager and one must be a System retiree.

⁴² § NRS 286.150(3).

⁴³ Of the five members appointed by the Governor, two shall have a minimum of five years of experience in the direct management, analysis, supervision or investment of assets; one shall have at least five years of direct experience in the management and administration of employee benefit plans; one shall be a local employee; and one shall be a faculty member or employee of a state supported institution of higher education.

⁴⁴ The Governor designates which of the nine members of the Board shall serve as chairperson, subject to confirmation by the General Assembly. The chairperson may serve no more than two consecutive two-year terms.

⁴⁵ The [Secretary of the Department of Administration](#) or designee is a member and two participants in the [Wisconsin Retirement System](#) (a representative appointed by the Teachers Retirement Board and a representative of other participants appointed by the Wisconsin Retirement Board).

⁴⁶ Six public members appointed by the Governor: four with at least ten years of investment experience, and one with at least ten years of financial experience and employed by a local government active in the [Local Government Investment Pool](#).

⁴⁷ Ten voting... the Treasurer, The director of the Department of Retirement Systems, The director of the Department of Labor & Industries. There are also five non-voting, Non-voting members serve in an advisory capacity on the WSIB and are selected by voting members based on their experience and expertise in investment matters

⁴⁸ All three must be retirement system members (one retired and two active)

TABLE I-A-1 – REVIEW OF BOARD SIZE, MEMBER REPRESENTATION GOVERNOR'S APPOINTMENT AUTHORITY AND TERM OF CHAIR					
PENSION FUND	BOARD SIZE	MEMBERS APPOINTED BY THE GOVERNOR	GOVERNOR DESIGNATES CHAIRMAN?	CHAIR'S TERM	Member Representation of the Board
<i>Arizona State Retirement System</i>	9	9 ⁴⁹	No - Chair Elected By Board	<i>Annual</i>	<i>Yes</i>
California State Teachers Retirement System	12 ⁵⁰	5 ⁵¹	No	Annual	Yes
<i>Colorado PERA</i>	16	0	No – Chair elected by Board	<i>Two years not to exceed two consecutive terms.</i>	Yes
<i>State of Michigan Investment Board</i>	Treasurer is Sole Trustee ⁵²	3- IAC See note ⁵³	N/A	N/A	N/A
<i>New York State Teachers Retirement System</i>	10 ⁵⁴	0	No- "President" elected by Board	<i>Annual</i>	<i>Yes</i>
<i>North Carolina Retirement System⁵⁵ (has Two Boards)</i>	14 & 17 ⁵⁶	10 & 13	No- Elected by the Board	Annual	Yes

⁴⁹ Five members representing the membership of ASRS and four with at least ten years of substantial investment experience (A.R.S. §38-713)

⁵⁰ Three member-elected positions representing current educators, five appointed by the Governor and confirmed by the Senate,, four board members who serve in an ex-officio capacity by virtue of their office: Director of Finance, State Controller, State Superintendent of Public Instruction, and State Treasurer.

⁵¹ A retired CalSTRS member and a school board representative appointed by the Governor and confirmed by the Senate and three public representatives appointed by the Governor and confirmed by the Senate.

⁵² The Treasurer has an Investment Advisory Committee (IAC) composed of the director of commerce, the director of the department of management and budget, or their duly authorized representatives, and 3 public members appointed by the governor with the advice and consent of the senate. The IAC advises the Treasurer on investment policy and can compel the Treasurer. The IAC may also, by a majority vote, direct the Treasurer to dispose of any holding which in the committee's judgment is not suitable for the fund involved, and may by unanimous vote direct the Treasurer to make specific investments.

⁵³ Investment Advisory Committee is composed of the director of commerce, the director of the department of management and budget, or their duly authorized representatives, and 3 public members appointed by the governor with the advice and consent of the senate.

⁵⁴ Three teacher members are elected from the membership, one each year, by delegates at an annual meeting held in the fall; one NYSTRS retiree is elected by a mail vote of all retired members, two school administrators are appointed by the Commissioner of Education.; two present or former school board members, experienced in the fields of finance and investment, are appointed by the Board of Regents from recommendations of the New York State School Boards Association. (At least one appointee must have experience as an executive of an insurance company.); one present or former bank executive is appointed by the Board of Regents; and the State Comptroller or designee.

⁵⁵ Teachers' and State Employees' Retirement System, Local Government Employees' Retirement System, Firemen's Pension Fund, Rescue Squad Workers' Pension Fund, Consolidated Judicial Retirement System, N.C.

TABLE I-A-1 – REVIEW OF BOARD SIZE, MEMBER REPRESENTATION GOVERNOR'S APPOINTMENT AUTHORITY AND TERM OF CHAIR					
PENSION FUND	BOARD SIZE	MEMBERS APPOINTED BY THE GOVERNOR	GOVERNOR DESIGNATES CHAIRMAN?	CHAIR'S TERM	Member Representation of the Board
Ohio Public Employees Retirement System	11 ⁵⁷	4	No – Chair elected by Board	Annual	Yes
State Teachers Retirement System of Ohio	11 ⁵⁸	1	No – Chair elected by Board	Annual	Yes
Oregon Public Employees Retirement Fund ⁵⁹	6 ⁶⁰	4 ⁶¹	No – Chair elected by Board	Annual	No
Oregon Public Employees Retirement System ⁶²	5	3	No	Annual	Yes

National Guard Pension Fund, and the Legislative Retirement System. Collectively these are referred to as the North Carolina Retirement Systems.

⁵⁶ The State Treasurer is responsible for administration of the Fund and is the CIO. The Board of Trustees governing the State and Local Retirement Systems is composed of two governing bodies. The first is the Board of Trustees of the Teachers' and State Employees' Retirement System, defined by NC General Statute 135-6(b). The Board of Trustees governing the Teachers' and State Employees' Retirement System has 14 members. The State Treasurer and Superintendent of Public Instruction serve ex officio. Ten members are appointed by the Governor and confirmed by the Senate. One member is appointed upon the recommendation of the Speaker of the House of Representatives and one member is appointed upon the recommendation of the President of the Senate. NC General Statute 135-6 makes the State Treasurer ex officio chairman of the Board. This Board is responsible for the administration of the Teachers' and State Employees' Retirement System, in addition to the Consolidated Judicial Retirement System, Legislative Retirement System, and Supplemental Retirement Income Plan (NC 401(k) Plan). The second is the Board of Trustees of the Local Governmental Employees' Retirement System, defined by NC General Statute 128-28(c).

⁵⁷ 6 elected, 4 appointed and 1 statutory.

⁵⁸ 5 elected contributing teacher members; 2 elected retired teacher members; an investment expert appointed by the governor [1]; an investment expert appointed jointly by the speaker of the House and the Senate president [1]; an investment expert designated by the treasurer of state [1]; and the superintendent of public instruction or her designated investment expert [1]

⁵⁹ The OPERF is managed by the Oregon State Treasury, under the direction of the Oregon Investment Council. The Oregon State Treasury does not administer the Oregon Public Employees Retirement System. PERS is directed by its own independent board and administered by [its own agency](#) based in Tigard, Oregon.

⁶⁰ The State Treasurer is a voting member and the CIO. The Director of the Public Employees Retirement System is an ex officio member with no voting power.

⁶¹ The Governor appoints four voting members who must be qualified by training and experience in the field of investment or finance and who may not hold any other public office or employment. They are subject to Senate confirmation.

⁶² This Board is not responsible for investments. It is responsible for the administration of the retirement system.

TABLE I-A-1 – REVIEW OF BOARD SIZE, MEMBER REPRESENTATION GOVERNOR’S APPOINTMENT AUTHORITY AND TERM OF CHAIR					
PENSION FUND	BOARD SIZE	MEMBERS APPOINTED BY THE GOVERNOR	GOVERNOR DESIGNATES CHAIRMAN?	CHAIR’S TERM	Member Representation of the Board
Texas Teachers Retirement System	7	7 ⁶³	Yes ⁶⁴	At pleasure of Governor	Yes
Median	9.5	4			

The aggregate impact of the SERS Board’s composition and structure coupled with the authority of other agencies of the Governor over the administration of SERS (e.g., the Governor’s Office of General Counsel) give the Governor and the Chairman, who is “designated by the Governor from among the members of the board,”⁶⁵ unusually strong control over SERS. To some Board members this is appropriate since the covered employees are state employees. Other Board members, however, believe that the System would benefit by changes such as including Board members elected by the System’s members, or giving the Board, rather than the Governor, the power to name the Board’s Chairman to render the Chairman more responsive to the Board. For example, some Board members are concerned that a Chairman serving at the discretion of the Governor, rather than at the election of the Board he or she chairs, could be less responsive to individual Board members when it comes to issues such as placing issues on the Board’s agenda. More generally, some interviewees indicated that they view the System as an executive branch agency, a status inherently in conflict with the Board’s fiduciary responsibility to the System’s members.

⁶³ The Governor appoints all seven members of the Board with the advice and consent of the senate. However, three of the seven must be persons who have demonstrated financial expertise, who have worked in private business or industry, and who have broad investment experience, preferably in investment of pension funds, and the remaining four are picked from elected slates provided to the Governor by the membership of the fund.

⁶⁴ A member of the Board is designated by and serves at the pleasure of the Governor (§ 825.201 Texas Code)

⁶⁵ Retirement Code Sec. 5901(a).

IFS believes that taking steps to reduce the Governor's control over SERS would enhance the Board's ability to assure that SERS and its Board members have the level of autonomy appropriate to its underlying mission which, as articulated in the Mission Statement, is properly focused on providing benefits and services to the SERS members. However, choosing the most effective changes requires careful consideration. For example, adding new Board members elected by the membership would, of course, increase the size of the Board which, as indicated above, is already large.⁶⁶ This could impair the Board's efficiency and complicate the way in which it conducts its meetings, which Board members indicated were well-run, providing opportunities for thorough deliberation in a reasonable time frame. We also recognize that legislation would be necessary to restructure many of the features of Board structure discussed, and that the outcome of a legislative process cannot be predicted. In addition, we acknowledge that the Governor's control is mitigated somewhat by the requirement that the Governor's appointees be confirmed by the Senate. Nonetheless there are some steps the Board can take which can begin the process of increasing the Board's autonomy.

Recommendations IA-1 and IA-2	SERS Response
<p><i>The Board should support and implement legislation to give the Board the power to elect the Board's Chairman for a fixed term not to exceed two years, with the legislation making clear that the Board members' votes on the election of the Chairman are fiduciary acts subject to the same standard of prudence that applies to all their decisions regarding the management of the System. We are not proposing term limitations. Consequently, a member could serve successive two year fixed terms.</i></p>	<p>CONSIDERED: The present board structure provides for continuity in executing long term strategic business, investment, and information technology plans and has served the Fund well. The structure's design serves to mitigate distractions or divisions at the board level that might otherwise arise due to a chairmanship election. The current structure has served the Fund and its membership well as born out by top decile long term returns, a well diversified plan, employer contribution costs that have been significantly below normal cost, and a funded ratio that is the envy of many peers throughout the country.</p>

⁶⁶ We are advised that the largest union representing Commonwealth employees covered by the System has traditionally been represented on the Board. That representation is not legally required.

Recommendations IA-1 and IA-2	SERS Response
<p><i>The Board should support and implement legislation establishing a process for nominations by the SERS membership (or organizations certified to represent the membership) for some number of the Board seats appointed by the Governor.</i></p>	<p>CONSIDERED: The current statute requires that at least five board members be active members of the system, and at least two shall have ten or more years of credited state service. In addition, the Executive Director of the AFSCME Council 13 representing the largest union membership and over 40,000 current employees, is on the Board. Increasing the size of the board would not appear to be value additive.</p>

As noted earlier, unlike several of the peer group pension fund entities, the SERS Board does not include any board members who are required by law to have investment or financial expertise. We understand that governors have, in practice, historically considered such expertise in naming appointees, but reliance on individual incumbents' judgment is no substitute from a legal requirement. We acknowledge that during the interview process some Board members expressed reservations about requiring certain board members to have investment expertise. One concern is that such members will not be sufficiently interested in other important issues the Board deals with. In addition, compliance with the conflict of interest and ethics rules applicable to the Board may make it difficult to find active investment professionals eligible to serve. On balance, IFS believes that requiring investment expertise on the part of at least some⁶⁷ members of the Board would enhance the Board's ability to set and to revise investment policy and to monitor its execution.⁶⁸

⁶⁷ There is no magic formula for establishing how many Board members should have investment expertise. Our Recommendation stated immediately below in the text speaks of legislation requiring "at least one" of the Governor's appointees have investment expertise. The Governor would be free, of course, to appoint more than one person with investment expertise to the Board, and even adding one such Board member would likely improve the Board's effectiveness as an investment decision-maker.

⁶⁸ We acknowledge a concern exists that having a Board member with investment expertise could create conflicts, depending upon the member's affiliations in the financial industry. IFS believes that certain types of investment professionals would be less prone to conflict, e.g., a finance professor or retired professional, and that appropriate recusal procedures would mitigate potential problems.

Recommendation IA-3	SERS Response
<p><i>The Board should support legislation requiring that at least one of the Governor’s appointees to the Board have investment expertise. And in the absence of such legislation, the Board could recommend to the Governor that he or she fill one or more vacancies on the Board as they arise with individuals with investment expertise.</i></p>	<p>CONSIDERED: The SERS’ Board through sound personnel hiring practices has established an Investment Office staffed by well qualified investment professionals. In addition, the Board through sound due diligence has hired experienced well qualified investment consultants and investment managers. This core group of investment professionals provides the Board with the expert investment advice necessary to manage SERS.</p>

Finally we note that while legislators appoint members to several of the pension entities (see Exhibit D in the Exhibits Section of this Report), only one member of the SERS peer group (Washington State Investment Board) includes legislators. While this renders the SERS Board distinctive, we do not view the inclusion of legislators on the Board as inconsistent with sound pension fund governance. The legislative members of the Board are subject to the same fiduciary standard of undivided loyalty as the rest of Governor’s appointees and the State Treasurer when functioning as SERS Board members. And if one considers that the legislature participates in various “settlor” functions regarding SERS such as establishing the level of benefits and appropriating the contributions, including legislators on the board is analogous to the standard, and legally required, practice of including employer representatives on the boards of “Taft-Hartley” funds in unionized private sector industries.⁶⁹ Consequently, the legislative members of the Board can be effective advocates for SERS as its administrative budget goes through legislative review by the General Assembly.

⁶⁹ “Taft-Hartley” funds are private sector employee benefit plans to which employers contribute pursuant to collective bargaining agreements with unions. Federal law enacted in 1947, known as the Taft-Hartley Act, requires that such funds be governed by a board of trustees consisting of equal numbers of representatives of contributing employers and the unions representing the participants. Reference to Taft-Hartley funds again points up the absence of Board members selected by the System’s members or their representatives.

***SERS Has Developed an Impressive Mission Statement
and its Investment Policy Statement Addresses
the Roles and Responsibilities
of the Parties Involved in the Investment Process***

SERS has adopted and posted on its website a simply worded Mission Statement which states, “The mission of SERS is to provide retirement benefits and services to our members through sound administration and prudent investments.” The Mission Statement was most recently amended in October, 2004, goes on to articulate “Guiding Principles” which were presented to the Board in October 2005, including:

- Demonstrate Integrity
- Think Strategically
- Lead Change
- Support Innovation and Improvement
- Develop and Empower Others
- Share Knowledge
- Foster Stakeholder Relationships

Each “Guiding Principle” is followed by several bullet points articulating specific aspects of the conduct necessary to promote realization of the particular principle. It is an impressive statement in that it addresses the key issues of integrity, innovation and communication in both its relations with the System’s members and the System’s internal processes.

The Board has also adopted Bylaws codifying basic procedural rules for the Board’s functioning. And the Board’s Statement of Investment Policy concisely delineates the roles and responsibilities of the Board, the Executive Director, Chief Investment Officer, the Investment Advisors (i.e., the external investment managers), the several Investment Consultants, the Internal Auditor, the Portfolio Evaluation Advisor (who may be the General Investment

Consultant) and the State Treasurer (in his/her capacity as custodian of the SERS assets, not as a Board member).

Our review of the Board's minutes and our interviews indicate that the SERS Board members act on a broad range of investment policy issues. In addition, the full Board votes on each commitment to alternative and private equity investment vehicles, some of which involve figures as low as \$10 million, which represents less than 0.04% of the SERS assets. It is one thing, and appropriate, for the Board to consider and decide upon the basic investment policies and guidelines pursuant to which individual investment decisions are made, and to monitor their implementation. The Investment Policy Statement specifically contemplates that the Board will approve the engagement and termination of investment managers, and the Board has occasionally rejected recommendations from the investment staff and consultants.⁷⁰ However making individual investment decisions requires time-consuming and detailed analysis. Almost without exception, the minutes show that the Board adopts the staff's recommendations with respect to individual investments. It is unclear how bringing individual investment commitment decisions in the private equity, real estate and other alternative investment asset classes to the Board enhances the quality and efficiency of decision-making.⁷¹ Delegating these issues to qualified staff, accompanied by a requirement that staff report these decisions to the Board on a regular basis would permit the Board to focus on the policy-level issues appropriate for their attention, and leave the Board in the position of retaining fiduciary responsibility to monitor the staff's performance, just as they monitor the performance of the external managers.⁷²

⁷⁰ SERS staff advises that, for example, the Board had rejected recommendations to terminate one manager and had selected managers other than those recommended by the staff and consultant for emerging market debt and European equity mandates. Representatives from IFS observed a SERS Board meeting on September 14, 2005. At that meeting a recommendation was made by the investment consultant and supported by investment staff. After discussion, the recommendation was not implemented.

⁷¹ Our observation is limited to private equity, real estate and other alternative investment.

⁷² IFS is not aware of any impediment in the Retirement Code or elsewhere in Pennsylvania law which would prohibit such a delegation, and neither SERS staff nor the Auditor General's office has brought such a provision to IFS's attention after inquiry.

Recommendations IA-4 and IA-5	SERS Response
<i>The Board should develop and adopt a formal Statement of Governance Principles.</i>	CONCUR: Staff will develop a formal Statement of Governance Principles for Board consideration.
<i>The Board should consider delegating to qualified staff authority to make certain investment decisions related to private equity, real estate and alternative investments, subject to guidelines established by the Board, with appropriate reporting requirements to the full Board or an appropriate Committee.</i>	CONSIDERED: The board believes the current process has served the System well. The process provides an approach whereby staff and consultant research the most highly skilled investment advisors and innovative products and present them to the Board for consideration and deliberation. Additionally, the current approach also incorporates using the Board approved discretionary reserve to fund top tier managers. The discretionary reserve acts to fund those opportunities in an accelerated manner and mitigates the procedure of Board presentations and deliberations prior to funding.

b. Use of Committees

Committees can provide a systematic, focused approach for board members to deal with issues and achieve objectives. Smaller groups can generally work more efficiently and less formally. To function effectively, committees should have a charter which describes the scope and authority of each committee, their goals and their strategies for accomplishing them, and timelines for completing goals.

SERS has not Developed an Ongoing Committee Structure

SERS provided IFS with a list of the Board's committees, as follows:

- Audit
- Securities Litigation
- Personnel

- General Consultant
- Real Estate Consultant
- Alternative Investment Consultant
- Deferred Compensation Program

The Committees range in size from three to five members and the Chairman is a member of each. There is no formal charter for any of the Committees other than the Audit Committee, and the three “Consultant” committees only function to conduct searches for new investment consultants. Unlike many of the peer retirement systems, SERS does not have an investment or finance/budget committee or a technology committee and, as a practical matter, does not use a committee structure to vet issues before they are presented to the full Board by the staff and consultants for action.

The absence of a robust committee structure may be responsible for the sense among some Board members that the Board is overly dependent on the staff⁷³ and consultants (although we were advised in our interviews that the Board actively questions the staff and consultant about their investment recommendations, and has on occasion declined to implement investment recommendations from staff and consultants.⁷⁴ In addition, the fact that the Board’s committees are not routinely active further consolidates the Chairman’s control over the range of issues the Board considers since no Board members routinely function as Committee chairs who can lead the Board’s consideration of particular issues. While, as set forth below, IFS recommends that SERS make more use of committees, care will need to be taken to assure that committees do not micromanage the staff and external service providers in the performance of functions properly delegated to them. In addition, the division of responsibility between the Board and its committees should be structured to avoid duplication of effort on the part of individual Board members and staff.

⁷³ Unless and until the Board delegates actual investment decision-making authority to staff, the Board needs a structure to ensure considered evaluation of the recommendations it receives from staff and its consultants.

⁷⁴ See footnote 65 above.

Recommendations IA-6 and IA-7	SERS Response
<p><i>The Board should establish committees in the areas of investments, budget and technology to meet and review staff and consultant recommendations in these areas and report regularly to the Board.</i></p>	<p>CONSIDERED: The staff annually provides and obtains Board comments on drafts of a Strategic Business Plan and an Investment Plan. The Board then adopts the final versions of these plans. These plans include the technology and investment initiatives the System will be addressing during the year. Throughout the year the Board is provided status reports relating to the progress of the Plan. SERS believes this approach provides a more efficient and effective approach to managing the operation than establishing various committees to address these same initiatives.</p>
<p><i>The Board should, by formal resolution, adopt charters for each of its committees to detail the scope and limits of their authority and the subjects within their jurisdiction, and their basic rules of procedure.</i></p>	<p>WILL CONSIDER: Where appropriate, staff will draft charters for Board approved committees.</p>

3. Information Technology - Investment Operations

a. Sufficiency of the Investment Accounting System for Investment Needs

Defined broadly, an investment accounting system includes all of the various books of original entry of transactions that, when combined, would constitute the *investment subsidiary ledger*⁷⁵ to the general ledger. The ideal goal of an investment accounting system is to capture transactions at the time of execution. However, the realities of a global, diversified portfolio require several books of original entry at several locations that are not linked automatically for combination into one system.

⁷⁵ An “investment subsidiary ledger” constitutes the detailed records that support the investment line items in the General Ledger.

For example, records for stock and bond investments, i.e., purchases and sales, originate from money managers who direct trades to brokers and dealers. Related income, dividends, and corporate actions originate from the issuers of the securities. These public market transactions ‘settle’ through and are captured and maintained by Mellon Trust, SERS’ custody bank, but transactions for real estate and private equity investments in private markets do not settle through the custody bank⁷⁶ and are maintained elsewhere. These transactions must be communicated to Mellon for aggregation.

Similarly, SERS gathers the data from the various sources and posts it to its General Ledger in order to capture aggregate investment information in the System’s *financial* accounting system to enable preparation of GAAP financial statements and other reports, such as the asset allocation report. SERS also posts summary data to the Pace-Eagle data warehouse to maintain investment data from various sources.

SERS Relies on the Custody Bank to Maintain Investment Accounting Records

Because of the complexities discussed above, SERS does not have an ‘all-in-one’ investment accounting system that automatically collects and records transactions as they are executed and from all sources. To our knowledge no such comprehensive global investment accounting system exists to collect automatically *all* transactions from *all* sources *at time of execution*. This is a common characteristic in the industry where funds invest in numerous externally managed and alternative asset classes and rely on third parties to capture accounting transactions at the source, aggregate them, and relay them later to the fund.

Rigorous and Periodic Tri-party Reconciliations are Performed

⁷⁶ The term ‘custody bank’ is used to avoid confusion with the State Treasurer who is the statutory ‘custodian’.

Key internal control processes that are essential to provide checks and balances on investment accounting and subsequent valuation processes involve the custody bank, SERS staff, and external manager personnel. These controls include periodic share and market value reconciliations between the original transaction and the recorded amounts. We understand that these reconciliations are rigorous and performed under the guidance of written procedures and supervisory reviews. IFS did not test the performance of reconciliations.

A fund may have more than one set of investment records for the same transactions and assets, e.g., the custody bank's records, the fund's records and the manager's records. One set should be deemed the official set upon which reports are based, aka the Investment Book of Record (IBOR). The investment accounting system may be defined more narrowly as synonymous with the IBOR. Currently at SERS, the IBOR is comprised of the custody bank's record of combined transactions.

However, because of legitimate concerns to facilitate accounting control over investment assets when such control points are needed, e.g., when the custody bank changes, and to preserve a historical record of transactions, e.g., to support securities class litigation, SERS maintains the Pace-Eagle⁷⁷ data warehouse to keep a historical record of holdings and transactions.

When the custody bank keeps the books and has custody of the assets, the fund's fiduciaries need assurance that internal controls exist and are functioning properly to ensure that the assets are protected and the books are accurate. Ordinarily, combining these functions creates a conflict of basic separation of duties. Thus, from a pure internal control perspective IFS generally believes that the pension fund should maintain the official book of record for investment accounting in order to provide that assurance. However, IFS also believes that there are situations where using the custody bank as the official book of record affords adequate

⁷⁷ The Pace Eagle data warehouse is SERS' terminology for its investment transaction database.

internal controls at a reasonable cost. The relationship between SERS and Mellon appears to be one of these situations⁷⁸.

In the case of SERS, it appears that sufficient internal controls and control activities have been established in order to allow it to maintain its investment accounting by the custody bank, i.e., several parties, including SERS, are involved in various stages of the investment process, e.g., execution, affirmation, settlement, valuation, etc. IFS did not test controls.

Economically speaking, the decision to use the custody bank as SERS' investment accountant incurs minimal costs to the System because the custody bank currently provides investment accounting as part of its fee, which is reasonable. From an efficiency standpoint, the benefits from using the custody bank for investment accounting include relieving significant staff resources and expertise that would be necessary in development and/or maintenance of an investment accounting application. These resources are available to focus on development of new mission critical resources and applications that could be used to enhance other areas of service. Additionally, investment staff are relieved from accounting related duties to focus attention on monitoring and managing the investment program and investment managers rather than on investment accounting systems issues.

Finally, SERS does not rely on the investment accounting system to provide information for daily management of the portfolio. Therefore, the decision to keep the custody bank as the official investment recordkeeper has no impact on SERS' current portfolio management processes. Thus, we recommend that SERS continue to rely on the custody bank to maintain the investment accounting records.

⁷⁸ The relevant controls (at the custody bank) would have to be identified, evaluated, and tested periodically in order to make a definitive conclusion. The bank's SAS 70 report may *not* provide the required assurance since it is designed primarily for other purposes.

b. Adequacy and Sufficiency of Access and Access Controls

Access control systems and practices should be designed to protect information from the threat of unauthorized disclosure, modification, or destruction. Access controls should strengthen the confidentiality, integrity, and availability of information assets primarily by identifying and authenticating data, and users.

***SERS' Access Control Policies and Procedures
Appear to be Thorough and Adequate
to Protect its Information Technology Infrastructure⁷⁹***

SERS adopts Information Technology Bulletins (ITBs) promulgated by the Governor's Office for Information Technology.⁸⁰ Additionally, based on the policies and procedures that were provided for review, SERS has developed sophisticated written access control policies and procedures covering all aspects of its information technology infrastructure, from access to the main building – to the computer room – to end user applications, and encompassing all levels of control, from physical barriers to user ids and passwords. Access controls at SERS range from manual processes that require human intervention in order to identify authorized users, such as entering numbers in digital door locks, to automatic controls that lock workstations after inactivity and require user passwords to unlock. User ids become disabled after three consecutive invalid access attempts. Users are required to use complex passwords that are seven characters in length and change them every 60 days. The SERS system retains six prior passwords to prevent their re-use. Also, users are able to change their password in the event that they believe it has been compromised. Further, SERS identifies authorized individuals in official Office of Information Technology written policies and procedure bulletins by their role, function and title. These written policies and procedures are distributed to staff and available on the SERS intranet.

⁷⁹ Our comment is limited to investments. Invested assets are custodied at a separate and secure location at Mellon Trust, DTC, and other depositories and repositories. The access controls over investments at SERS appear adequate.

⁸⁰ The Office of Administration/Office for Information Technology (OA/OIT) is responsible for developing and administering statewide policies and standards governing management and use by agencies under the jurisdiction of the Governor of the Commonwealth's information technology (IT) resources.

Staff is required to acknowledge by signature select policies such as the policy on internet usage, but they do not acknowledge and agree to all IT policies and procedures.

Recommendation IA-8	SERS Response
<i>Staff should be required to acknowledge by signature the receipt of, and agreement to, all IT policies and procedures.</i>	CONCUR: Staff will develop the appropriate document for signature by all staff members.

c. Sufficiency of Backup Policies

Information backup procedures should be designed to help protect information assets of the System by allowing for the ability to promptly restore computer applications, operating systems, and data to its most recent state in the event of corruption or accidental erasure.

***SERS' Backup Policies are Sophisticated and Thorough
and Appear Sufficient for their Designed Purpose
of Aiding Prompt Recovery of Data***

SERS uses an Oracle database to store data for the Pace-Eagle system. SERS' written policies and procedures address numerous types of tape backups performed for its databases. These backups consist of full hot backups⁸¹ on Sunday and Wednesday and incremental hot backups on the other days. A daily archive is also created to backup files that have changed since the last hot backup. As an added measure, a full database export is created once a week on the server. This export is then backed up during the routine server backup procedure. Finally, in addition to the standard tape backups to cartridge tape and the full database export, SERS creates 'standby databases' that are copies of each production database but maintained on identical servers located in a different building.

⁸¹ A hot backup is one performed on data that is actively accessible to users and may be in a state of being updated. Performing a hot backup does not require downtime.

d. Sufficiency of Disaster Recovery

Disaster Recovery Planning (DRP) procedures help protect information assets of the System in the event of an unforeseen catastrophe and allow for the continued ability to provide services while reducing the operational and financial impact of the loss or destruction of critical systems and data.

4. The Roles of Audits, Reporting and Compliance Group (“ARC”), Internal Audit, Compliance and the Middle Office

The Current Role of ARC Includes Management Functions that are not Appropriately Separated from the Internal Audit Activity

The Audits, Reporting and Compliance group provides two primary activities within its three sub-sections. The Internal Audit function and the Compliance function monitor organizational controls and investment activities. The Financial Reporting function performs financial and managerial accounting tasks. These three sub-sections report to the Director of Audits, Reporting and Compliance who reports to the SERS Executive Director. Such an organizational structure creates the appearance of a lack of independence in cases where Internal Audit needs to audit the Compliance and Reporting functions since Internal Audit reports to the head of Compliance and Reporting.

Recommendation IA-9	SERS Response
<i>SERS should establish the internal audit activity as a functional unit that is independent of the organizational activities it is supposed to audit. (Please see Recommendations IA-1- and IA-11 on the middle office below.)</i>	WILL CONSIDER: SERS is reviewing the alignment of responsibilities within certain bureau functions.

The Role of a Middle Office

The term “middle office” implies a functional group that sits between the “front office” (investment management and trading) and “back office” (clearance, settlement, accounting, and reporting). SERS has no such dedicated “middle office” currently. We believe that the middle office structure described below would be valuable to SERS and that the general notion of maintaining a middle office appears to be a sound evolution of the ARC group as discussed above.

Certain Current Activities of ARC are Good Candidates for a Middle Office Function or Relocation to Other Areas

A first step in establishing the “middle office” is the development of its mission statement and objectives. The functions and responsibilities identified in Table I-A-2 below should assist SERS in this effort. As a support unit for management and the Board, the primary goals of the middle office could be to help management reduce risk and enhance efficiency. Its fundamental functions would revolve around investment compliance and risk management. These concepts should be incorporated into the statement of mission and objectives.

A middle office that is independent of portfolio management provides a means of independent review. As an example, the middle office can be responsible for monitoring aspects of investment performance and risk measurement, trading compliance and attribution analysis for performance measurement (rather than for portfolio management). To avoid the potential conflict of investment officers measuring and monitoring their own performance and compliance, the portfolio management staff should not perform these functions.

The general rule for units whose function is assessing compliance is to report outside the functional group being monitored. To the extent that the middle office performs support services for other internal units, independence is less important. Thus, it is sensible to have the middle office report to someone other than the CIO. The middle office concept in public pension plans

is relatively new and, therefore, middle offices do not have generally similar structures. Usually, there is an effort to reconfigure some front office and back office functions and consolidate them with certain newly established functions, with the intention of segregating responsibilities for improved internal control. This model would be applicable to SERS' current situation.

Some of the more common responsibilities of a middle office center around coordination of performance measurement source data, coordination of new systems and analytics among the investment accounting and information technology functions, coordination with the custody bank, project management, risk management and reporting, monitoring securities lending, transaction costs and trading performance, and analytical support.

There is no standard template for designing such a unit, either in its functions or in its place in the organization. As more public funds establish these departments and gain experience with them, some consensus may develop. Ultimately, how best to divide basic responsibilities will remain a matter of preference for each individual fund. We have prepared Table I-A-2 as a graphic representation below to suggest a more logical location for certain functions under the assumption the SERS will establish a middle office.

Table I-A-2: ARC Functions and Responsibilities			
Current ARC group/function	Proposed Location of Function		
	Middle Office	Internal Audit	Other Area
Internal Audit Group			
Internal Audits		X	
1099 Reviews			X – Office of Financial Management ("OFM")/ Accounting
Member Statements			X – Member services
Year end Audit assistance			X – OFM/Accounting
Special projects	X		
Reporting Group			
Year end close			X – OFM/Accounting
All financial reporting and reconciliations			X – OFM/Accounting
Year end audit assistance			X – OFM/Accounting
Monthly Asset Allocation report	X		
Monthly Statement of Changes			X – OFM/Accounting

Current ARC group/function	Proposed Location of Function		
	Middle Office	Internal Audit	Other Area
Compile asset values	X		
Real Estate & Private Equity transaction recording and cash flow reports	X		
Assess controls over financial reporting			X – Internal Audit
Process class actions	X		
Maintain GASB/FASB knowledgebase			X – OFM/Accounting
Regulatory report prep (Form S, Form BE-82, etc.)	X		
Budget support			X – OFM/Accounting
Review actuarial and other reports			X – OFM/Accounting
Quarterly exception report	X		
Compliance Group			
All compliance monitoring activities	X		

Recommendations IA-10 and IA-11	SERS Response
<i>SERS should establish a Middle Office in order to enhance internal controls, specifically separation of potentially incompatible functions.</i>	CONCUR: SERS is in the process of developing and staffing an office such as the one recommended.
<i>Certain investment related accounting functions now performed by Audits, Reporting and Compliance should be modified as necessary and performed in the Middle Office as described in the accompanying Table I-A-2.</i>	WILL CONSIDER: SERS is reviewing the alignment of responsibilities within certain bureau functions.

Please see DAG's response at Exhibit G for comments on this section.

I-B. Due Diligence Procedures

1. Due Diligence and the Process of Selecting Investment Managers

a. Overview

Selection of appropriate investment managers is complicated and requires good judgment. To be successful, the decision about which manager to hire must be based on a solid foundation of fact and analysis. Most institutional investors employ an independent investment consulting firm to identify the best candidates and perform due diligence, to confirm investment returns, to compare these returns to a wider universe of funds and managers, and to provide information on the risks incurred by the investment managers. Consultants have a natural advantage in that they are able to routinely monitor a wider range of investment managers than a single fund can on its own.

IFS has conducted numerous reviews of public employee pension funds over the last ten years. In these reviews, we have observed a wide variety of practices when it comes to the analysis and selection of investment managers. Further, we serve as investment consultant to over 60 employee benefit funds and we have almost two decades experience in evaluating investment managers and recommending the most appropriate managers to our clients. Our own experience and industry practice strongly suggests that the process of due diligence should involve:

- collection of a wide range of information and data on a large number of managers;
- analysis of those managers to determine which offer the best balance of qualifications, organizational stability, investment philosophy, process and skill, resources and results;

- winnowing the larger list down to a reasonable number for intensive review;
- interviews with the key investment decision makers at each firm to test their investment decisions and their ability to communicate clearly about strategy and process; and
- participation of several parties (usually the Board, its staff and an investment consultant) that compare their findings, review one another's conclusions, and confirm the most salient facts about each candidate.

The due diligence process should also leave a clear documentary trail that demonstrates what factors were considered and how a decision was made.

Thoughtful, careful and comprehensive due diligence procedures improve the likelihood that the Board will make successful investment decisions when it comes to the selection of investment managers. Absent careful due diligence, the Fund may find that it has employed investment managers who lack skill or whose style of management is inappropriate for the Fund's investment program.

Thorough due diligence during the process of manager selection better prepares the Board and its staff to understand how that manager will perform in different investment climates and to monitor the performance of those managers who are ultimately selected. Clarity with respect to a manager's investment style and strategy are essential during those inevitable periods when the manager's investment returns fail to meet the Fund's expectations. Effective due diligence on the "front end" reduces the risk that the Fund may later decide to terminate or replace a good manager who is experiencing a period of weak performance.

b. Review of SERS Manager Search Procedures for Public Equities and Fixed Income

***SERS' Due Diligence Procedures are
Thorough, Complete and Well-Documented***

As we have found to be the case with other large, well-managed public sector pension funds, SERS' due diligence process effectively combines the efforts of an experienced and capable staff with a sophisticated and well-resourced investment consultant. However, SERS' process is distinguished by the extent to which its process is well-documented. The Fund's staff has clearly invested substantial time and effort in both developing the due diligence process and in documenting it. Written procedures exist covering hiring and managing investment managers, creating guidelines for each manager account, assigning market benchmarks, managing cash flows, evaluating investment manager performance, monitoring investments and updating the Fund's investment policy. With respect to this documentation, the Fund's procedures surpass industry best practices (or create a new, higher standard for everyone else).

SERS' due diligence process is firmly anchored in a larger planning and management context. The Fund prepares an Annual Five-Year Investment Plan that includes investment initiatives for the year and reference to any manager searches that may be required (either due to a change in investment structure or to the failure of an incumbent manager). Staff and the general investment consultant work in parallel to identify candidates for a position in the Fund's manager roster. Staff employs the Wilshire Compass database (includes historical performance and other characteristics of investment management firms), while Rocaton (SERS general investment consultant) makes use of the "eVestment Alliance" database of manager returns. Staff and the consultant generate a "long list" of candidates (anywhere from 10 to 50 names, depending on the assignment).

The consultant reports that it sends a questionnaire to the initial list of candidates. In joint discussion, staff and Rocaton then edit the list of candidates to less than 10 for the purpose of interviews. Following interviews involving senior investment staff at the Fund, staff and the consultant agree on a shorter list of finalists to recommend to the Board. Either staff or Rocaton (or both) make site visits to the offices of the finalists, allowing them to probe deeper into investment and operational issues like back office functions and trading. Staff and Rocaton joint author a report to the Board explaining their findings. The Board makes the final decision on the selection of managers.

Both staff and the consultant have a sophisticated understanding of investment manager styles and strategies. They make use of appropriate analytical tools to screen and to evaluate managers. The reports prepared for the Board are comprehensive and clear, creating a solid foundation for the Board's own deliberations on managers. The Board gives staff and the consultant high marks for communication. The due diligence process is thorough and complete. The Board reports that it is satisfied with the work of the staff and the consultant regarding manager selection and due diligence.

Recommendation

No recommendation necessary.

2. Monitoring External Investment Managers

a. Overview

In a world in which new information constantly enters the financial markets and a market somewhere in the world is always open, securities prices fluctuate rapidly and significant amounts of volatility or "noise" cloud our ability to observe manager skill or "alpha." It is by no means an easy matter to separate the contribution made by an investment manager's style, skill and luck. Institutional investors must employ sophisticated techniques to monitor the

performance of investment managers to unravel the interplay of risk, returns, and costs in the portfolios those managers construct.

As mentioned above in the “Overview” under section 1. Due Diligence and the Process of Selecting Investment Managers, IFS has conducted numerous reviews of public employee pension funds over the last ten years where selection and monitoring of external managers has been a subject of review. In these reviews, we have observed a wide variety of practices when it comes to the monitoring of external and internal investment managers. Further, we serve as investment consultant to over 60 employee benefit funds and we have almost two decades experience in monitoring investment managers on an ongoing basis for our clients. Our own experience and industry practice strongly suggests that regardless of the size or complexity of a fund’s investment program, thorough and comprehensive monitoring of investment managers is widely considered to be essential. Many institutional investors rely on their general investment consultant to perform much of this task, with the Board receiving periodic reports on manager performance. Others have fund staff deeply involved in the process. Some combination of staff and consultant review is the approach most commonly pursued by major funds. No matter who performs this function, several key components are required:

Investment performance: Track holdings; account for cash flows and transactions; calculate periodic investment rates of return; compare returns to appropriate benchmarks, and rank in a universe of peer managers.

Investment risks: Based on portfolio holdings, evaluate portfolio characteristics such as price/earnings, price/book, dividend yield, earnings growth ratios (for equity) and maturity, duration, yield, convexity (for fixed income); observe how portfolio holdings are distributed among sectors and industries; calculate measures of volatility for the portfolio; compare characteristics, diversification and volatility to that of an appropriate benchmark and manager peer group. Estimate the role of investment style in the manager’s returns (if relevant to the investment structure of the fund). Apply

sophisticated portfolio analytic systems to estimate the risk of the portfolio on a forward looking basis (such as estimated tracking error).

Compliance: Compare individual holdings within a portfolio to the guidelines set for the manager to determine if there are any holdings that lie outside of the permitted securities for the account. Confirm that the account is consistent with any portfolio-wide requirements established by the guidelines. Identify any variances and investigate further.

Periodic, in-depth review of managers: Review long-term performance in light of the risks incurred by the manager; estimate the sources of return in a manager's portfolio and compare to the fund's expectations (attribution). Meet with the manager's key personnel to discuss results and strategy; make site visit if possible. Confirm organizational details, such as key investment personnel, sufficiency of resources, growth of business, trading and proxy practices.

Regular, focused and thorough review provides the information needed by the fund's Board to untangle investment style, skill and luck from the noise of capital markets. Effective monitoring has two benefits: it helps the Board make good decisions, and it also signals to the manager that the fund is serious about performance and compliance.

b. Review of SERS Procedures for Monitoring External Equities and Fixed Income Managers

SERS' Monitoring Procedures are Essentially Complete

The Fund has a sophisticated investment program that relies entirely on the use of a large number of external investment managers. Monitoring these managers is performed by the SERS Director of Public Markets, the SERS directors responsible for each asset class, and the general consultant. The monitoring process is composed of several components. First, the general

investment consultant obtains investment manager rates of return from the Fund's custodian bank and prepares regular reports on manager performance and aggregate risk measures. These reports are thorough with respect to manager market values, investment returns and benchmark comparisons, but light with respect to measures of investment risk, manager style, portfolio characteristics and peer group comparisons. Second, staff attempts to meet with each investment manager annually in the office of the Fund, providing the opportunity to discuss any changes in the managers' personnel or organization as well as investment issues. Third, staff maintains a formal watch list for tracking those managers whose performance fails to meet the Fund's expectations or who experience organizational, personnel or procedural changes. The qualitative and quantitative criteria for incumbent managers and the purpose and use of the Watch List are outlined in the SERS "Public Markets Investment Advisor Retention Guidelines." Fourth, SERS has a compliance monitoring program that confirms that external managers fulfill the requirements of their mandates and stay within the risk parameters set for each portfolio. Taken together, these steps comprise a consistent and effective approach to monitoring external managers.

***The Board Should Consider Including More Information on
Investment Risks in the Regular Reports It Receives***

The Board should consider whether it would benefit from receiving more detail on the risks incurred by the Fund's investment program. Staff report that they have discussed recently with the Board the amount of risk reporting presented in the general consultant's regular investment performance reports, and that the Board indicated to staff that the Board was satisfied with the level of detail. Staff stated that they have the capability to generate more information on investment risks within the program, but that they do so only on an "ad hoc" basis. However, in light of the fundamental relationship between investment return and risk, some more substantial measures of risk⁸² should be incorporated into the regular investment performance report received by the Board and should be a routine part of the Board's review of investment

⁸² Such measures of risk might include portfolio characteristics, industry and sector weightings, standard deviation of returns, tracking error, information ratios, or other statistical measures where relevant and appropriate.

performance. Investment returns are a first (and crucial) component of regular review of the program, but measures of risk should play an equally prominent role.

Similarly, most institutional investors monitor the performance of the total fund by comparing it to that of their peers. They compare the returns achieved by the individual managers they employ to those of peer groups of managers that invest according to similar investment styles and strategies. Staff expressed doubt that such peer group comparisons are useful, but did indicate that staff is evaluating new analytical tools available from the Fund's custodian that allow the comparison of portfolio characteristics to a universe of peer managers. We understand, however, that SERS surveys 40 large public pension funds semi-annually regarding performance and asset allocation and reports this information to the Board.

Compliance Reviews are Well Managed

The Fund has a compliance process in place that involves dedicated staff and the Custodian. Staff use a compliance software module provided by Mellon ("Investment Monitor"), a rules-based system that produces compliance checks automatically. Staff drafts the rules that are coded into the system, performs a monthly run, and reviews the system's output. When the compliance check identifies an exception, staff reviews the exception for materiality and investigates the reasons. If significant, the compliance staff documents the exception and forwards the report to the relevant asset class director at the Fund. The CIO receives total fund characteristics across all portfolios and asset classes.

This year, the Fund's compliance staff met with the directors responsible for each asset class to review manager guidelines and the compliance rules, and where necessary, the rules were modified to reflect each manager's mandate more accurately. Directors have responsibility for resolving the exception. Some send the compliance reports to the managers involved, while others have a conversation with the managers. The directors are expected to respond in writing to

the compliance staff. Compliance staff reports that they have the discretion to report any disagreements or unresolved exceptions to the Director of Public Markets.

The compliance staff is also responsible for a variety of related functions, such as:

- Reviewing monthly reconciliations between the investment managers and the Custodian;
- Checking the positions of long-short managers to confirm market-neutrality of the portfolio; and
- Checking the notional value of swaps contracts and producing exposure reports.

Staff reports that the compliance process is accurate and timely. The Fund's extensive compliance program, integrated with the Custodian's systems, represents a best practice.

***The Sophistication of the Fund's Investment Structure
Compels It to Evolve Monitoring Methodologies
That Can Measure New Risks***

As stated above, the Fund is distinguished by the sophistication of its investment program. The Fund is clearly on the cutting edge of the public pension fund investment world. Its use of "portable alpha" strategies, swap contracts, hedge funds, long-short strategies, commodities, and currency overlays offers the prospect of enhanced investment returns, results that are sorely needed when traditional stock and bond investments may not produce the level of returns seen in the 1990's. The potential for greater returns inevitably carries the threat of unexpected risks, great volatility and operational risks not seen in a more pedestrian investment structure. At the same time that it invests substantial time and effort in developing innovative investment strategies, the Fund must strengthen the procedures it uses to identify, measure,

evaluate and control investment and operational risks. Here too, the Fund must distinguish itself in the coming years by the sophistication of its risk management systems.

The Fund's staff and consultant should pool their extensive skills to develop the ability to measure the contribution of each of these new strategies to total portfolio risk. Total fund risk measures should be complemented by risk measures at the asset class level. In particular, the Fund should consider whether it can effectively monitor:

- Leverage across a variety of strategies, especially with respect to the investment of "collateral" backing any derivative positions;
- Use of fixed income and mortgage instruments that may have interest rate sensitivities that are fundamentally contrary to the sensitivities of conventional securities in the bond market (e.g., interest-only securities, inverse floaters, exotic tranche securities, etc.);
- Interest rate sensitivity or "duration" of its derivative-based and commodity strategies, as well as in its fixed income portfolios;
- The extent to which its long-short strategies are truly market-neutral;
- The extent to which the Fund's alternatives holdings may be influenced by unexpected volatility in, or the direction of, public equity markets;
- The correlations of these "moving parts" in the investment structure and the extent to which correlations may change through time; and

- The extent to which the Fund may be vulnerable to “contagion” or event risks that have derailed other globally invested programs involving emerging market equity and debt, currencies and other credit “spread” products.

At the end of the day, the Fund may well find it necessary to develop a new paradigm for risk management, one for which its past history as a conventional pension fund investor may not be sufficient. The Fund does have a detailed “Derivatives Investment Policy Statement” and does not allow the use of derivatives “to magnify exposure to an asset” or “to create exposures to securities.” Nonetheless, the extensive use of derivative positions such as futures, options and swaps creates the need to strengthen the Fund’s ability to monitor the effective exposures created in the aggregate by its investment managers. The Board and staff have not indicated any plans or interest in managing derivatives positions internally, but if it were to do so, the Fund would need to strengthen its internal controls. The Fund must look outside the practices of its pension fund peers and consider the experience of banks, insurance companies and hedge funds over the last ten years as these investors struggled to deal with trading problems. Most of all, the Board must ensure that it has sufficient information to exercise oversight of such a sophisticated investment program.

Recommendations IB-1, IB-2 and IB-3	SERS Response
<i>The Fund’s methods for monitoring managers and investments are sound, but should be enhanced to reflect the sophistication of the Fund’s investment program.</i>	CONCUR: SERS is researching and discussing best practices for monitoring new and innovative investment strategies with consultants and investment advisors and is working toward developing an effective approach toward risk reporting and measurement.
<i>The Board should reconsider whether it would benefit from receiving more detail on the risks incurred by the Fund’s investment program. If so, it should clarify for staff and the consultant the amount of detail on portfolio risks it requires.</i>	CONCUR: SERS and consultant have expanded disclosure of portfolio level metrics to the Board.

Recommendations IB-1, IB-2 and IB-3	SERS Response
<i>The Fund should enhance its monitoring procedures to meet the specific challenges created by use of sophisticated “alpha transport”, “long-short” or derivative strategies. The Board should instruct staff and the general consultant to develop additional analysis that can evaluate the risks and returns of these strategies.</i>	CONCUR: SERS is researching and discussing best practices for monitoring new and innovative investment strategies with consultants and investment advisors and is working toward developing an effective approach toward risk reporting and measurement.

3. Investment Guidelines for Public Market Portfolios

a. Overview

Pension fund “best practices” generally indicate that to manage investment risk properly at the individual manager level separate customized investment guidelines shall be developed and provided to each investment manager (whether internal or external). Guidelines are essential for monitoring, measuring and analyzing portfolio performance, risk, and structure relative to the objectives.

Such guidelines are typically drafted by the fund’s investment consultant and incorporated into the manager’s contract, in order to hold the manager legally responsible to comply. Investment managers should be allowed to provide input into the draft guidelines to assure they are appropriate without unduly limiting the manager’s ability to manage according to its style and earn a rate of return above the appropriate market benchmark.

In both our operational review work of public pension plans and our retainer consulting of ERISA covered plans discussed earlier in this section, we have evaluated and developed

numerous guideline documents for various investment strategies⁸³. Guidelines should define the style of investment management employed by the manager and identify specific metrics (such as performance as well as other characteristics) by which the staff and Trustees can determine whether the manager is doing what the manager was hired to do. Overall equity and fixed income guidelines should generally include, among other items:

- Limits on the amount that any manager can own of the securities of a single corporate issuer (typically 5%);
- Limits on the percentage portfolio weight in any one security;
- Investment objectives, including the style specific performance benchmark and other expectations regarding performance (e.g., perform in the top half of a designated universe);
- A requirement that the portfolio's holdings within industry sectors be limited to an amount specified in writing pursuant to a system of industry classification to be agreed upon between the fund and each equity manager;
- Prohibitions on use of certain securities, such as derivatives; and
- Prohibitions on margin transactions or any borrowing of money.

Inadequate guidelines could potentially allow an investment manager to invest assets in accordance with a strategy other than that it was engaged to pursue, possibly causing the portfolio to take on different risk and structural characteristics than desired by the client.

⁸³ Notably, our firm helped develop the model set of investment guidelines proposed by the U. S. Department of Labor and adopted by the court in the Lowen v Tower Asset Management case. This model is widely cited as industry standard under ERISA and serves as a basis for our own activities as an independent fiduciary.

b. Review of SERS' Investment Guidelines

***SERS' Guidelines are Essentially Complete
but Could be Enhanced***

SERS has developed individual guidelines for each separate account investment manager (called "Investment Strategy Statements"). We believe that it is best practice to have individual guidelines for each investment portfolio. We reviewed a random sampling of the guidelines for the various asset classes, and in general, found them to be largely complete. Most of the guidelines are very similar, except for the necessary subtleties attributable to the manager's specific investment style, but a few guidelines did not appear to follow the typical format. We review a few specific examples below.

Provident Investment Counsel Mid Cap Growth Investment Strategy Statement (effective 10/6/2000): The mid cap growth equities guidelines for this manager contained an informative section on the manager's investment strategy and process as well as most of the essential elements, including:

- Investment objectives and return requirements,
- Risk and diversification criteria (e.g., expected number of issues, constraints on sector weightings versus the Russell Mid Cap Growth Index),
- Certain characteristics such as expected capitalization,
- Maximum amount allowed in cash (10%),
- Prohibited investments, e.g., derivatives, unregistered stock, and

- Direction that trading should be subject to best execution.

Based on our experience and expertise, model investment guidelines would include the following additional elements not seen in the Provident document:

- Fiduciary standard of care,
- Requirement to maintain fiduciary liability insurance,
- Proxy direction (e.g., whether the investment manager should vote them),
- Action required for breach of guidelines, and
- Communication and reporting requirements (including requirement to report organizational changes at the firm or material changes in investment philosophy or strategy).

Morgan Stanley International Equity Portfolio Investment Strategy Statement (effective 12/1/2004): For the most part, our comments on the Provident guidelines apply to this Morgan Stanley portfolio. It is worth noting, however, that in accordance with best practices since this is an international equity portfolio, currency hedging is addressed (and in this case it is allowed under certain circumstances). In addition, since Morgan Stanley is a market maker⁸⁴ and underwrites issuance of new securities, the guidelines appropriately address potential conflicts in the firm's management of the Fund's portfolio.

⁸⁴ A "market maker" is a firm that stands ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price. www.sec.gov.

Taplin, Canida & Habacht, Inc. Fixed Income Investment Strategy Statement (effective 12/1/2000): Although the Taplin, Canida & Habacht (TCH) guidelines are of a similar vintage as the Provident guidelines, they contain some of the elements we felt were missing from Provident's, such as:

- Communication - annual meetings are required, and
- Reporting – the format for the portfolio summary report is specified.

We did notice some disparities among the guidelines, however, for example:

- Provident's performance is to be evaluated over an economic cycle whereas several other managers (e.g., Pictet, Artisan, among others) are evaluated based on their annualized five year total return, others (e.g., Morgan Stanley) state five years or a market cycle and some (e.g., TCH) state a three to five year time horizon.
- Volatility is addressed in different ways: e.g., Provident in terms of tracking error and TCH in terms of standard deviation of returns compared to that of the index.
- Morgan Stanley's Domestic Core Fixed Income Global Fixed Income guidelines do outline specific reporting requirements.

We understand that a few of the above items that we did not find in the guidelines are included in the investment manager's contract⁸⁵, such as general reporting requirements, fiduciary standard of care, insurance requirements. We think it is satisfactory to include these

⁸⁵ SERS appears to use a standard investment manager contract for its managers, which we consider to be a best practice, rather than relying on the investment manager's standard contract.

items in the contract, as the manager's guidelines are an exhibit to the contract, as is the System's IPS. However, we maintain that certain subjects should be addressed separately in the guidelines, such as: proxy voting (for equity managers) and any specific reporting or communication requirements, including what should be done if there is a breach of guidelines.

Recommendation IB-4	SERS Response
<p><i>Review the investment guidelines for consistency and, in order to enhance the usefulness of the guidelines, consider including additional requirements (even if they are covered generally in the IPS), where appropriate to the asset class, such as:</i></p> <ul style="list-style-type: none"> <i>• proxy voting,</i> <i>• specific communication and reporting requirements, and</i> <i>• required action in case of a breach of guidelines.</i> 	<p>CONCUR: As a matter of practice, staff review guidelines formally for each manager at least annually.</p>

4. Alternative Asset Classes and Real Estate Due Diligence

a. Overview

Review of investment opportunities in private equity and real estate typically involve many of the same procedures as are applied to the selection of managers in publicly traded stocks and bonds. Most funds start by collecting information on a broad array of managers and investment vehicles, and then narrow review to those considered most appropriate for a given fund. These managers are investigated in detail, with attention paid to the organization, the caliber of its professionals, track record of returns, portfolio composition, risks, the investment process, and the specific structure of a fund or limited partnership. Most institutional investors employ specialist consultants to assist in this work. Similarly, some funds hire staff with direct experience in each field.

Private equity and real estate differ from stocks and bonds in that the analysis and experience needed to select good managers is industry-specific. Both asset classes are distinguished by the illiquidity of the underlying assets, and therefore any investment should be expected to have a longer investment horizon. Transaction costs are also substantial, making it more difficult to change holdings once an initial purchase or investment is made. Information on managers, funds and performance is less readily available, and consultants play a bigger role in collecting and condensing information. Finally, private equity investments tend to be riskier and more unpredictable, with a distinct possibility in many cases that an initial investment may ultimately be worth little.

b. Review of SERS' Procedures

***SERS' Monitoring Procedures are
Thorough and Complete***

The Fund has assigned separate asset class directors to alternatives (private equity) and real estate. Both work with specialty consultants hired by the Fund to assist with asset class strategy, investment structure, manager or partnership selection, monitoring those investments made by the Fund, performance reporting, and other associated investment issues. In real estate, the Fund gives broad discretion to its separate account managers to buy, sell, lease and maintain the Fund's properties. In private equity, staff and the consultant identify managers or partnerships for investment, prepare reports for the Board's consideration, and rely on the Board to make a final decision on specific partnerships. Both the alternatives and real estate consultants maintain databases on managers and funds, and both provide the Fund access to a broad range of opportunities for investment.

Both consultants demonstrate substantial knowledge of their respective asset classes and the investment managers. Both have served the Fund for an extended period and provide valuable "institutional memory." Based on our review of their work product, both consultants

produce reports that are thorough and the content of, and analysis provided within, these documents are consistent with industry best practices. In interviews, both consultants described their due diligence procedures in a manner that indicated that the procedures were thorough and appropriate to the needs of the Fund.

Similarly, staff members in the private market area are knowledgeable and have a strong understanding of effective due diligence procedures. Staff's description of its due diligence efforts is consistent with industry best practices. Staff and the consultants work closely together to review investment managers and funds, to select those that offer the best opportunities to the Fund, and to prepare materials to brief the Board on the managers and funds. Staff and the consultants report that they seek to reach consensus on any decisions made or recommendations forwarded to the Board.

Recommendation IB-5	SERS Response
<i>The Board should continue to maintain direct communication with both staff and the specialty consultants so that the Board can insure that the close working relationship between staff and the consultants does not dampen any reasonable difference of opinion between about strategy, managers or performance.</i>	CONCUR: The consultant is present at each Board meeting to present its views and to address any questions and concerns of the Board as they arise.

Please see DAG's response at Exhibit G for comments on this section.

I-C. Legal Matters

1. Adequacy of Legal Resources

Managing pension fund assets requires expert legal advice. The trustees of a public pension fund need attorneys knowledgeable in the interpretation and application of the complicated laws governing their funds, experienced in reviewing and negotiating agreements with investment managers, consultants and service providers and familiar with the legal issues surrounding emerging investment issues such as private equity, venture capital, class action litigation and corporate governance. Given that a public pension board typically consists of trustees who, although appointed by various stakeholders, owe a duty to the fund's participants and beneficiaries, the attorney for the board should have unconflicted loyalty to the fund. While fund attorneys are generally not considered "fiduciaries" in the same way that trustees are, they have a similar duty of loyalty derived from the professional canons of ethics which govern the legal profession. As the Official Comment to Rule 1.7 of the American Bar Association's Rules of Professional Conduct states, "Loyalty and independent judgment are essential elements in the lawyer's relationship to a client."

If a public fund's attorney's loyalty and independence are compromised, the fund is at risk of being guided by legal advice colored by conflicting obligations and the attorney's need to accommodate interests other than the interests of the fund's participants and beneficiaries. When the attorney is selected by and answerable to the government that employs the participants and funds their benefits, there is inherent tension between the employer/funding source and the participants and beneficiaries. It is reasonable to be concerned that the attorney will be torn between those conflicting constituencies. One day the issue may be the fund's right to collect funding contributions from the employer, or the interpretation of a new statute creating a benefit entitlement with significant funding consequences depending on the interpretation. Another day counsel may be called upon to opine on the prudence of an investment decision that may be

contrary to the Executive Branch's proprietary or political interests, or another question involving the Board members' fiduciary judgments. The fact is that a public pension fund is different from other government agencies in that its governing body, the Board, has a specific fiduciary duty to one segment of the Commonwealth's population, the members of the System. Accordingly, a public fund is best served by an attorney whose duty runs exclusively to the fund's fiduciaries, unimpaired by a simultaneous duty to other public officials who do not have a fiduciary responsibility to the fund's members. It is the inherent characteristics of the relation between a public fund and the rest of the governmental apparatus which create the potential for conflicts of interest when the fund shares its attorney with the state government, not the personal conduct of individual attorneys whose good faith is not the issue.

***SERS Does not have Access to Legal Counsel with an
Unconflicted Loyalty to the Interest of SERS***

The SERS Board does not hire or fire its legal counsel, and does not set their compensation. SERS receives legal advice from a staff consisting of a Chief Counsel and three Deputy Counsels, all of whom are appointed by the Commonwealth's General Counsel. The General Counsel is an appointee of the Governor, pursuant to the Commonwealth Attorneys Act. The Commonwealth's General Counsel is responsible for supervising, evaluating⁸⁶ and setting the compensation of the Chief Counsel and the Deputy Counsels, and the Commonwealth General Counsel has the power to fire the SERS Chief Counsel and Deputies. In addition, when the Chief Counsel decides that a particular matter (such as a real estate transaction or litigation) requires the engagement of outside counsel with specialized expertise, the General Counsel must approve the law firm.

⁸⁶ The Governor's Office of Administration (the "Office of Administration") has developed a new Attorney Performance Evaluation and Compensation System for evaluating and setting the compensation of attorneys in the General Counsel's office. The new system includes a Client Feedback Form which agencies such as SERS are to complete. One of the questions on the form asks client agencies to evaluate whether the particular attorney "demonstrates firmness and assertiveness in pursuing or protecting the interests of my agency."

The fact that SERS' legal counsel is an employee of and under the control of the Commonwealth's executive branch creates an inherent structural conflict of interest, as explained above. The Governor's control, through the General Counsel, over the SERS attorney is inconsistent with the Board's purported status as an independent⁸⁷ body with a membership representative of multiple stakeholders, all of whom, unlike the Governor, have a fiduciary responsibility to the SERS membership. In reality, the interests of the Governor are not necessarily always aligned with the interests of SERS and its Board. That is not peculiar to SERS. It has become a recognized best practice for a public retirement system to have the authority to engage its own legal counsel.⁸⁸ This structural problem is mitigated, but not eliminated, by the current SERS Chief Counsel's awareness of and sensitivity to the issue, but that of course does not assure that every future Chief Counsel will share those attributes.⁸⁹ IFS' judgment on this matter (and indeed all of the governance and structural issues addressed in this report) cannot be and is not influenced by the personal integrity and conscientiousness of the individuals holding positions at SERS at the moment. Our focus is on identifying structural attributes of the System that create risks or could impair efficiency and effectiveness, even though the good will and judgment of particular Board members and staff may mitigate those risks and overcome those impairments at a particular point in time. A good governance system consists of structures and processes that will mitigate those risks and enhance the System's

⁸⁷ Although Retirement Code Sec. 5901(a) describes the Board as "an independent administrative board" it is also apparently an "executive agency" rather than an "independent agency" within the meaning of Sec. 732-102 of the Commonwealth Attorneys Act.

⁸⁸ Uniform Management of Public Employee Retirement Systems Act ("UMPERSA") Sec. 5(a)(2). IFS regards UMPERSA, promulgated in 1997, as a source of "best practices" because of the thoroughness of the process by which the National Conference of Commissioners on Uniform State Laws drafts, debates and revises its uniform laws. While only Maryland and Wyoming have adopted UMPERSA, more states have adopted various of its components. IFS understands that Pennsylvania cast the only vote against adoption of UMPERSA when it was adopted by the National Conference of Commissioners on Uniform State Laws. The Commonwealth General Counsel represents the Commonwealth at the National Conference. Commonwealth Attorneys Act Sec. 732-302.

⁸⁹ IFS recognizes that, as SERS' attorney, the Chief Counsel has an ethical obligation of loyalty to the System. The Official Comment to Rule 1.7 of the Pennsylvania Rules of Professional Conduct, 204 P.S. Sec. 81.4, contains the same language regarding an attorney's duty to loyalty to his or her client as the parallel provision of the A.B.A. Rules of Professional Conduct quoted at page 68. The Pennsylvania Rules also articulate a "lawyer's obligation zealously to protect a client's legitimate interests, within the bounds of the law, while maintaining a professional, courteous and civil attitude toward all persons involved in the legal system." 204 P.S. Sec. 81.1(10). It is by no means clear, however, that the General Counsel has such a duty of loyalty to the System in deciding on the appointment, compensation or removal of the System's Chief Counsel, Deputy Counsel and Assistant Counsels.

efficiency and effectiveness in ways that, to the extent possible in a system operated by people, are not so dependent on the good intentions of particular individuals.

The General Counsel's control over SERS' selection of outside legal counsel has reportedly impaired the efficiency of SERS' direct real estate investment program. The Board grants complete investment discretion to the outside advisors of the real estate accounts. However, the outside advisors cannot hire legal counsel of their choice to do the specialized legal work for the title-holding entities formed to own the properties, even though the advisor is ultimately accountable for the investment and legal work is a critical aspect of managing direct investments in real estate. Rather, the manager is required to submit its proposed choice of counsel to the Office of General Counsel for approval, and is frequently required to consider other firms selected by the General Counsel. This process adds delay in an area where decisions often need to be made quickly. We were advised that there have been instances in which the outside counsel ultimately approved by the General Counsel was not the firm the advisor would have selected based on the advisor's consideration of cost, market experience, expertise with the particular transaction at issue and the ability to respond in a timely fashion.

Table I-C-1 below presents a review of the authority of 21 other public fund boards' to select their own internal and external legal counsel. To conduct this review we utilized PSERS' (the shaded group) and SERS' customized peer groups plus the Teachers Retirement System of Texas in order to assess whether the state attorney general (or some comparable position) of these funds is designated as the legal advisor (or some comparable term) to the Board, whether they have own independent legal counsel (in-house or an outside law firm), and whether the attorney general must approve the Board's use of external legal counsel.

The majority of the boards in the peer groups (56.5% - 13 of 23)⁹⁰ have their own independent legal counsel (or have the authority to hire counsel). Even in the case where the

⁹⁰ SERS is excluded from the calculation as it is the subject of the comparison.

attorney general is designated as the legal advisor to the Board, seven of the seventeen funds (41%) nevertheless have their own independent in-house counsel (i.e., not under the control of an external entity). The majority do not have independent in-house legal counsel where the attorney general is the designated legal counsel – 10 of the peer group boards (59%). Further, the majority of the boards, even several of those with independent in-house counsel, must obtain the approval of the attorney general before they can use external legal counsel (a number of funds also use a pre-approved pool of attorneys to reduce the time required to go through the required approval process). Although this is a common practice, it is not consistent with best practices because it creates an inherent conflict and does not foster effectiveness and efficiency of the pension fund's operations.

Table I-C-1 – Board Authority to Select Legal Counsel			
Pension Board	Attorney General is Designated Legal Advisor to the Board	Board appoints its own independent in-house legal counsel	Attorney General must approve Board use of external counsel
Public School Employees Retirement System of PA	Yes	No	Yes
Iowa PERS	No	Yes	No ⁹¹
LACERA (has two boards – BOR & BOI)	Yes ⁹²	Yes	No ⁹³
Md. State Retirement and Pension System	Yes ⁹⁴	Yes	Yes
Mass PRIM	No	Not currently ⁹⁵	No ⁹⁶
Minnesota State Board of Investment	Yes	No	Yes
Mississippi PERS	Yes	No ⁹⁷	Yes

⁹¹ The CEO approves the use of external counsel

⁹² Pursuant to §31529 of the County Employees Retirement Law, the district attorney, or county counsel if there is one, is the attorney for the board

⁹³ ⁹³ Pursuant to §31529.1 and §31529.5 of the County Employees Retirement Law, the board is authorized to retain legal counsel.

⁹⁴ §21-107 - The Attorney General is the legal adviser of the Board of Trustees.

⁹⁵ The Board is authorized to employ legal counsel pursuant Chapter 32§23 of the Massachusetts General Laws and the Authorizing Trust.

⁹⁶ However, pursuant to Section 11.1, the Trustees shall give notice to the Attorney General of the Commonwealth of any legal proceedings.

⁹⁷ Special Assistant General Attorney serves as legal counsel

Table I-C-1 – Board Authority to Select Legal Counsel			
Pension Board	Attorney General is Designated Legal Advisor to the Board	Board appoints its own independent in-house legal counsel	Attorney General must approve Board use of external counsel
Missouri Public School	No ⁹⁸	Yes	No
MOSERS	No	Yes ⁹⁹	No
Nevada Public Employees	Yes	No	Yes
Virginia Retirement System	Yes	No	Yes
State of Wisconsin Investment Board	No	Yes ¹⁰⁰	Yes ¹⁰¹
Wash. State Investment Board.	Yes ¹⁰²	No	Yes
State Employees Retirement System of PA	Yes	No	Yes
Arizona State Retirement System	Yes	No	Yes
California State Teachers Retirement System	No	Yes ¹⁰³	No
Colorado PERA	Yes ¹⁰⁴	Yes	No
State of Michigan Investment Board	Yes ¹⁰⁵	No	Yes
New York State Teachers Retirement System	Yes	Yes	Yes
North Carolina Retirement System	Yes ¹⁰⁶	No	Yes
Ohio Public Employees Retirement System	Yes	Yes ¹⁰⁷	Yes

⁹⁸ The board may appoint an attorney or firm of attorneys to be its legal advisor. However, in the event that the board does not appoint a legal advisor, the Attorney General represents the board in legal procedures.

⁹⁹ §104.520 - The board may appoint an attorney or firm of attorneys to be the legal advisor* to the board and to represent the board in legal proceedings, however, if the board does not make such an appointment, the attorney general of the state shall furnish, upon request, whatever legal services are necessary. 104.520. The board may appoint an attorney or firm of attorneys to be the legal advisor* to the board and to represent the board in legal proceedings, however, if the board does not make such an appointment, the attorney general of the state shall furnish, upon request, whatever legal services are necessary.

¹⁰⁰ §25-156(3) of the 2005 Wisconsin Statutes provides that “the members of the board shall appoint chief legal counsel...”

¹⁰¹ Per staff, must obtain AG’s approval of any outside counsel who is paid for with trust fund assets.

¹⁰² A.G. serves as legal counsel to state agencies, boards and commissions

¹⁰³ In-house general counsel and external fiduciary counsel.

¹⁰⁴ §24-51-216 Colorado Revised Statute

¹⁰⁵ The investment function of Michigan state retirement systems is controlled by the treasurer, whose designated legal advisor is the AG.

¹⁰⁶ Attorney General is the legal advisor to the Board (N.C. §128-28(k)), the system is a division of the State Treasurer’s Office.

¹⁰⁷ In-house legal counsel and external fiduciary counsel.

Table I-C-1 – Board Authority to Select Legal Counsel			
Pension Board	Attorney General is Designated Legal Advisor to the Board	Board appoints its own independent in-house legal counsel	Attorney General must approve Board use of external counsel
State Teachers Retirement System of Ohio	Yes	Yes	Yes
Oregon Public Employees Retirement Fund	Yes	No	Yes
Texas Teachers Retirement System	Yes ¹⁰⁸	Yes	Yes

IFS recognizes that legislation would be required for the SERS Board to have the independent authority to engage legal counsel who would serve at the Board's pleasure, either as a staff attorney or by contract with an external firm. The autonomy we contemplate would include the authority to decide to use the Commonwealth's General Counsel for certain issues that do not raise potential conflicts, and as to which familiarity with Commonwealth law would render reliance on the General Counsel prudent.

The enactment of such legislation is by no means certain to occur soon, if at all. Until it is, a formal Memorandum of Understanding between the SERS Board and the General Counsel could establish criteria and processes for identifying issues that the Board should be able to review with legal counsel of its choice. Preparation of such a Memorandum *before* the next issue fraught with conflict arises will assure that the interests of SERS and its members will receive appropriate legal protection if and when those issues next arise. To the extent that Commonwealth law may require the concurrence of the Attorney General to such a Memorandum, the Attorney General should be included in the process of its negotiation.

¹⁰⁸ § 825.203. LEGAL ADVISER. The attorney general of the state is the legal adviser of the board of trustees. The attorney general shall represent the board in all litigation.

Recommendations IC-1 and IC-2	SERS Response
<p><i>The Board should seek, and subsequently implement, legal authority to hire a staff attorney who would be appointed by and serve at the pleasure of the Board, with administrative reporting responsibility to the Executive Director. That legal authority could take the form of appropriate legislation amending either or both of the Retirement Code and the Commonwealth Attorneys Act, or a binding, permanent directive from the General Counsel authorizing such an attorney's appointment. The Board should establish in writing the scope and limits of that SERS attorney's authority, as well as the relationship between the SERS attorney and the Commonwealth General Counsel.</i></p>	<p>CONSIDERED: There are advantages to having SERS' counsel be appointed by General Counsel and subject to the supervision of General Counsel. Such counsel owe a duty of loyalty and utmost care to SERS even though appointed by General Counsel. The Rules of Professional Conduct, which are applicable to both such counsel and General Counsel, should be sufficient to deal with any conflict situation. Indeed, even if SERS had authority to appoint its own counsel, it would often be relying on the integrity of that counsel to note instances of conflict and then on that attorney's compliance with the Rules of Professional Conduct. Finally, it is questionable whether one General Counsel could enter into an agreement binding on future General Counsels as to representation of SERS.</p>
<p><i>So long as a Chief Counsel appointed by and serving at the pleasure of the Commonwealth's General Counsel remains the SERS attorney of record, the Board and the General Counsel should negotiate a formal, written Memorandum of Understanding setting forth the procedures to be followed (i) to identify situations in which, due to a conflict of interest or a need for specialized expertise, SERS and/or its Board may engage its own legal counsel, and (ii) to select and compensate such separate counsel.</i></p>	<p>CONSIDERED: A memorandum of understanding is not a binding document. Also, it is not possible to contemplate in a meaningful way situations when special counsel may be needed. It should be sufficient to rely on compliance with the Rules of Professional Conduct.</p>

General Counsel and Attorney General Oversight of Contracting Adds Little Value

None of the Board, the Executive Director or the Investment Staff have expressed concerns with the quality or timeliness of the support of the Chief Counsel and his staff for the

investment functions (although, as indicated above, the General Counsel's involvement in the selection of outside legal counsel has reportedly been problematic with respect to the System's direct real estate investment program). One aspect of the legal review of transactions has, however, raised concerns, and that is the requirement set forth in the Commonwealth Attorneys Act that the General Counsel and the Attorney General review, with respect to form and legality (as opposed to business terms) and sign off on all agreements SERS enters into.¹⁰⁹ SERS' Chief Counsel's office has requested that the General Counsel and the Attorney General complete their reviews within tight time frames, and both offices have been responsive on that point. Some view input from the General Counsel and Attorney General as a useful "fail-safe" part of the process, particularly with regard to legal issues of general state-wide concern such as sovereign immunity and indemnification. However, since that input does not address the substantive business aspects of SERS' agreements, substantive value added from General Counsel and Attorney General involvement in SERS contracts has not been identified. Nor is it clear why both the General Counsel and the Attorney General should have to review all contracts for form and legality, particularly since the Chief Counsel must do so as well.¹¹⁰

The Commonwealth Attorneys Act contemplates that each of the Chief Counsel, the General Counsel and the Attorney General "may prepare uniform instrument forms and preapprove all such documents which are prepared in accordance with such forms and applicable instructions."¹¹¹ We understand that previous efforts by the SERS Chief Counsel to generate preapproved contract forms such as standard investment management agreements for preapproval by the General Counsel and Attorney General have not been successful but that additional efforts toward that end are currently underway. The increased use of standardized forms of agreement, pre-approved by the General Counsel and the Attorney General, has improved the efficiency of the process although it is still viewed as being burdensome.

¹⁰⁹ 71 P.S. Secs. 732-204(f) (Attorney General approval requirement) and 732-301(11) (General Counsel approval requirement). The law gives the Attorney General up to 30 days to consider a proposed contract.

¹¹⁰ 71 P.S. Sec. 732-402(6).

¹¹¹ See statutes referenced in notes 22 and 23 above.

We would expect that relieving SERS of the need for General Counsel and Attorney General approval of contracts could be accomplished in the course of establishing a legal department within SERS responsible exclusively to SERS and the Board, as recommended above. Meanwhile, so long as contract approval from statutory counsel other than SERS Chief Counsel is required, the use of standardized forms of agreement, pre-approved by the General Counsel and the Attorney General, can improve the efficiency of the process, especially if the preapproval gives SERS leeway to negotiate business terms for inclusion in the contract without requiring individualized contract approval from counsel other than SERS Chief Counsel.

Recommendation IC-3	SERS Response
<p><i>The Board should support the adoption of legislation amending the Commonwealth Attorneys Act to exempt SERS from the requirement to obtain approval of all contracts from the Attorney General and the General Counsel or, at the very least, to require approval from only one of them. Pending the enactment of such legislation, the SERS Chief Counsel should develop form contracts preapproved by the General Counsel and the Attorney General to obviate the need for review of individual contracts consistent with the pre-approved form, leaving SERS leeway to negotiate and finalize the business terms of its contracts with approval from the SERS Chief Counsel.</i></p>	<p>CONSIDERED: As has been noted, the review by the Attorney General is not for business terms, but rather to assure compliance with certain important mandates such as non-waiver of sovereign immunity. The Attorney General is aware of the time sensitive nature of approvals of SERS' investment agreements and has responded in a timely manner. SERS' Legal Office has sought, and continues to seek, ways to standardize agreements in a way that might obviate the need for the General Counsel's and Attorney General's reviews.</p>

2. Statutory Standards

It has become well established for pension fund trustees to be subject to a rigorous standard of fiduciary conduct when managing the pension fund's assets. One element of the fiduciary standard requires trustees to act solely in the interest of the pension system's members, rather than in the interest of themselves, their constituent group(s) or appointing authority, the public or taxpayers at large. This duty is commonly referred to as the "duty of loyalty." A critical second element imposes on pension fund trustees a "duty of care" standard. Under the

traditional law of trusts, a trustee is expected merely to act as would a prudent person when handling his/her own affairs. This common law standard is less demanding than the standard which the federal Employee Retirement Income Security Act of 1974, as amended (“ERISA”) imposes on the trustees of private sector benefit funds.

Under the ERISA prudent person standard a fiduciary must operate with the “care, skill, prudence and diligence under the circumstances then prevailing that a prudent [person] *acting in a like capacity and familiar with such matters* would use in the conduct of an enterprise of a like character and with like aims.” (Emphasis supplied). The trustees are not themselves required to be “experts” (unless the trustee has represented that he/she has greater skill than that of a man of ordinary prudence)¹¹² – or unless the law establishing the board requires that some number of its members be experts – but instead must exercise the care that another prudent person “familiar with such matters” would use to manage a comparable fund. While public pension funds are not subject to ERISA, and each state can and does formulate the fiduciary standard for the trustees of its public pension funds, the ERISA standard has become the model, as indicated by the use of a virtually identical formulation in UMPERSA.¹¹³ Permitting pension fund trustees to invest fund assets without being subject to a rigorous standard of care leaves trustees unaccountable for lapses which can impair the financial integrity of the assets under their control and management.

The SERS Retirement Code Articulates an Appropriate Standard of Fiduciary Responsibility

The Retirement Code explicitly imposes fiduciary status on “[t]he members of the Board, employees of the Board, and agents thereof.”¹¹⁴ The Retirement Code requires that the Board manage and invest SERS’ funds

¹¹² See Annot., Standard of Care Required of Trustee Representing Itself to Have Expert Knowledge or Skill, 91 A.L.R. 3d 904 (1979) & 1992 Supp. At 48-49.

¹¹³ UMPERSA Sec. 7. The official Comment to UMPERSA Sec. 7 observes that the ERISA standard has been adopted by “many states.”

¹¹⁴ Retirement Code Sec. 5931(e).

*subject. . .to the exercise of that degree of judgment, skill and care under the circumstances then prevailing which persons of prudence, discretion and intelligence, who are familiar with such matters, exercise in the management of their own affairs not in regard to speculation, but in regard to the permanent disposition of the funds, considering the probable income to be derived therefrom as well as the probable safety of their capital.*¹¹⁵

This formulation of a standard of care, which can be described accurately as a “prudent investor” standard,¹¹⁶ closely tracks the widely accepted standard of prudence articulated in ERISA and UMPERSA, two widely accept sources of appropriate standards for pension fund fiduciaries.¹¹⁷ One widely cited federal appeals court opinion interpreting ERISA described the ERISA fiduciary standard as “the highest known to law.”¹¹⁸ By explicitly referencing considerations such as income, probable safety of capital and “the permanent disposition of the fund,” the Retirement Code incorporates into the standard of prudence concepts such as risk and investment horizon which UMPERSA articulates and are meaningful elements of prudent investment decision-making.

¹¹⁵ *Id.*, Sec. 5931(a).

¹¹⁶ See Memorandum dated January 4, 2006 from the Chief Counsels of PSERS and the State Employees’ Retirement System to Christal Pike-Nase, Deputy Chief Counsel, Department of the Auditor General. We note that the Investment Policy Statement characterizes the Retirement Code’s formulation as a “prudent person” standard.

¹¹⁷ UPIA also articulates a “prudent investor” standard. IFS believes that while UPIA has been adopted in many more states than UMPERSA, the standards set in UMPERSA are a better model for public pension funds. The Prefatory Note to UPIA states that it is “centrally concerned with the investment responsibilities arising under the private gratuitous trust, which is the common vehicle for conditioned wealth transfer within the family.” While the Prefatory Note also states that UPIA’s provisions “also bear on charitable and pension trusts,” the management of public pension fund assets was not a central concern of UPIA’s drafters. More particularly, there is a significant difference between the prudence standards articulated in the two model laws. UMPERSA Section 7(3) requires that a fiduciary act with the “care, skill and caution under the circumstances then prevailing which a prudent person acting in a like capacity and familiar with those matters would use in the conduct of a like character and purpose.” (Emphasis supplied). The Official Comment to UMPERSA Section 7 states that this standard, derived from ERISA, does not permit comparison to a prudent amateur, in contrast to the UPIA standard for private trusts “where the law anticipates amateur trustees and allows comparison to prudent amateurs.” The Retirement Code appropriately reflects the more demanding UMPERSA/ERISA standard. We note, however, that the Retirement Code speaks to the prudence persons familiar with such matters would “use in the management of their own affairs” while public pension fund trustees are managing assets on behalf of others, i.e., the system’s members. However the reference to the duty of loyalty cited in the text adequately covers this difference.

¹¹⁸ *Donovan v. Bierwirth*, 680 F.2d 263, 271n.8 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).

The Retirement Code also provides (albeit indirectly) that fiduciary responsibility includes an “obligation to invest and manage the fund for the exclusive benefit of the members of the system,”¹¹⁹ the standard of loyalty which is part of the fiduciary standard in ERISA and UMPERSA. However the Retirement Code does not explicitly impose a duty on the Board to diversify SERS’ assets similar to the duty of diversification articulated in ERISA. Nonetheless, it is apparent from SERS’ Statement of Investment Policy and Annual Five-Year Investment Plans that the SERS Board has acted consistent with that duty.

While articulating most of the widely accepted elements of fiduciary responsibility, the Retirement Code avoids imposing legislated constraints on the Board’s discretion to invest the assets, such as “legal lists” or which impose percentage limits and, in some cases, outright bans on the portion of the assets which may be invested in particular categories of investments, without reference to their fitness under the fiduciary standards. This approach is consistent with ERISA, UPIA, and UMPERSA; indeed, the latter explicitly authorizes public pension fund trustees to “invest in any kind of property or type of investment consistent with” fiduciary standards.¹²⁰ By permitting the Board to invest subject to the standard of prudence, the statutory scheme gives the Board the flexibility to evaluate and implement new investment opportunities and techniques on their merits, without having to wait for the legislative process to catch up to developments in the marketplace.

One aspect of the statutory scheme that merits further examination, however, is the applicability of the statutory standard of care to Board members’ designees. If designees can be considered “agents” of the members of the Board within the meaning of Retirement Code Sec. 5931(e), they stand in the same “fiduciary relationship” to the SERS members as the Board members do. However, Section 5931(a), which articulates the prudence standard, applies by its literal terms only to the members of the Board themselves. While we are not experts in Pennsylvania law, the lack of a formal statutory provision binding designees to the prudent

¹¹⁹ *Id.*, Sec. 5931(e).

¹²⁰ UMPERSA Sec. 8(a)(4).

investor standard could allow imprudent designees to avoid liability for their conduct by asserting that the prudence requirement was not binding on them (although SERS' Chief Counsel avers that designees are bound to the same standards as the Board members themselves by operation of law). Since the Board's legislative members and the Treasurer, serving ex-officio, can and do act through their designees, it would be advisable, in order to remove all doubt, for there to be a clear and formal statement, having the force of law, holding designees to the same standard of prudence which applies to the Board members. We note with approval, however, that SERS' Bylaws require designees to take the same form of oath as the Board members for whom they act¹²¹ and that designees file disclosure statements pursuant to the Ethics Act discussed below.

Recommendation IC-4	SERS Response
<i>The Board should amend the Bylaws to add a provision clearly stating that designees of Board members are subject to the same standard of care as the Board members designating them.</i>	WILL CONSIDER: Although SERS believes that designees of Board members are subject to the same standard of care as the Board members, SERS will consider adding the suggested provision to its bylaws when they are next amended.

Private sector pension fund fiduciaries bound to the ERISA standard of prudence may be held personally liable for losses incurred by the funds they serve resulting from their breaches of fiduciary duty. It is beyond the scope of IFS' engagement to analyze the extent, if any, to which Commonwealth law's doctrines of sovereign immunity might protect SERS Board members from similar liability; we are advised that SERS believes that those defenses are available. That immunity does not, of course, mean that legal expenses, which may be significant, can be avoided if suit is brought against the Board for breach of fiduciary duty, and SERS' indemnification policy provides coverage for those costs. Accordingly, it is in the interest of the SERS Board members, as well as SERS itself, for Board members to obtain the training necessary for them to meet their challenging fiduciary responsibilities. This is because while it is

¹²¹ SERS Bylaws Sec. 1.5.

appropriate for fiduciaries to seek input and advice from professional experts, fiduciaries may not simply rely blindly on those experts. Rather, the fiduciary subject to a “prudent investor” standard retains ultimate responsibility for his or her decisions.¹²²

3. Legal Provisions that Constrain Performance

As indicated above, fiduciary standards in the pension fund industry are evolving away from “legal lists” in the area of investments, with trustees given authority to make investment judgments independent of categorical restraints, so long as they comply with a rigorous fiduciary standard. This trend is part of a broader movement toward giving public pension funds and their trustees greater autonomy, discretion and control over the management of pension fund assets. The autonomy advocated for pension trustees is intended to ensure that they can exercise independent judgment, consistent with fiduciary standards, to perform their duties effectively and efficiently. In exchange of this autonomy, trustees are subject to stringent fiduciary standards and liability for the breach of such standards, as well as reporting and disclosure requirements. The Official Comment to UMPERSA Section 5 states the point well:

Independence is required because it permits trustees to perform their duties in the face of pressure from others who may not be subject to [fiduciary] obligations. In the absence of independence, trustees may be forced to decide between fulfilling their fiduciary obligations to participants and beneficiaries or complying with the directions of others who are responding to a more wide-ranging (and possibly conflicting) set of interests. In this sense, ...independence...is an important corollary of the fiduciary obligations [trustees must comply with].

By invoking the value of trustee autonomy, IFS does not intend to imply that political actors outside the public retirement system in the executive and legislative branches do not have a role to play with respect to the system. Basic functions of deciding whether to establish the

¹²² D. Levin, T. Ferrera, ERISA Fiduciary Answer Book, Sec. Q 4:25 at 4-32-33 (4th Ed., Aspen Publishers, Inc. 2001).

fund, setting its benefit levels and establishing its funding policy, known in the ERISA setting as “settlor” functions, are traditionally outside the scope of fiduciary responsibility and trustee discretion. In Pennsylvania, as in most states, those functions are carried out through the legislative process. Thus, for example, the SERS rules involving eligibility for benefits, the level of benefits and the actuarial funding method for the benefit program all appear in the Retirement Code, a statutory enactment. In advocating for changes to enhance the SERS Board’s autonomy, IFS is not referring to those functions, which should properly reflect a judgment on behalf of the Commonwealth as employer, and not the SERS Board, as to what level of benefit liability to assume and how to pay for it.¹²³ But administering the fund and investing its assets are core fiduciary functions best performed by trustees subject to a rigorous standard of fiduciary conduct, with a duty to act solely in the interests of the fund’s beneficiaries and participants.

When autonomy is compromised, trustees may be forced to decide between fulfilling their fiduciary obligations to participants and beneficiaries or complying with the directions of others, who have no fiduciary responsibility, and who are responding to different and possibly conflicting interests, (e.g., budget balancing dilemmas, enhancing the tax base through in-state investing, pressures to enhance benefits in an unfunded liability environment, etc.) inconsistent with the Trustees’ fiduciary duties.

***SERS’ Authority is Compromised by Statutory Requirements
that Give the Executive Branch Considerable Influence***

As explained above, Pennsylvania law does not impose restrictions on investments that could have the effect of constraining the performance of SERS’ assets. However, certain provisions of law that apply to SERS’ operations may have that effect, and certainly impair the autonomy of SERS and its Board. As set forth below, we recommend that SERS be granted autonomy that it currently does not have to select its own legal counsel (as set forth above) and

¹²³ It is axiomatic that pension plan underfunding can as easily result from misjudgments by the legislative and executive branches in setting benefit levels and funding methods, which directly impact a plan’s liabilities, as from misjudgments in managing plan assets.

with respect to its budget, custodial, procurement and personnel processes (as set forth immediately below). These recommendations do not, however, include or imply a suggestion that SERS be freed from appropriate oversight. We do not recommend modifying the public disclosure and open meeting law requirements as they apply to SERS. Nor do we advocate changing any of the several public reporting and disclosure requirements applicable to SERS.¹²⁴ This public oversight, combined with the discipline of adhering to the rigorous standard of fiduciary responsibility described above, provide appropriate controls over a public pension fund.¹²⁵

a. Budget Process

Retirement Code Sec. 5902(c) provides that SERS' administrative expenses be paid from the investment earnings of the funds, not from the Commonwealth's general treasury. In addition, the SERS Board is, as discussed above, subject to a rigorous standard of fiduciary responsibility with respect to the SERS funds. These characteristics render SERS different from government agencies whose budgets are paid from appropriations, and are properly subject to political control. Nonetheless, the Retirement Code requires that SERS' administrative budget be submitted, through the Governor, to the General Assembly, and provides that only administrative expenses approved by the General Assembly may be paid from the investment earnings. Moreover, we are advised that if the General Assembly has restored an item to SERS' budget which the Governor had not approved, the Governor can require SERS to ask permission to make the expenditure. Thus, SERS' administrative budget is subject to the same political

¹²⁴ See, e.g., Retirement Code Secs. 5902(j) (requiring annual actuarial valuation, with certification to be included in the Annual Financial Statement, and actuarial investigation and valuation every five years, with tables to be published in the Pennsylvania Bulletin), (m) (requiring publication and distribution to Governor and "the head of each department" an annual financial statement) and (n) (requiring an annual audit of the System by an independent CPA.)

¹²⁵ IFS acknowledges that our recommendations to grant SERS this level of autonomy will require the enactment of legislation, and we do not offer an opinion as to how these proposals will be received by the General Assembly. We likewise acknowledge that the transition to autonomy in these areas will require careful implementation. Our observations give us no reason to doubt that the SERS Board and staff have the capacity to meet those challenges.

process as the rest of the Commonwealth budget approved by the General Assembly, even though SERS provides the funds to pay the expenses.

Subjecting SERS' administrative budget to this process renders SERS' Board subject to political constraints completely unrelated to the needs of the System, and the budget approval process has on occasion resulted in reductions from the budget proposed by SERS. Moreover, when staff prepares a proposed budget for approval by the Board, staff "self-censors" the proposal to reflect the Governor's Office of the Budget's expectations. The process effectively causes SERS to be treated as part of the executive branch of the government, rather than an autonomous agency, since the Governor's Office of the Budget, not the Board, decides what to submit to the General Assembly on behalf of SERS.¹²⁶ The presence of legislators appointed by legislative leaders on the SERS Board can be an effective counterweight since they are in a position to advocate in the legislature on behalf of SERS' interests. Additionally, the impact of the budget process on the SERS investment functions is somewhat mitigated by the fact that the costs of external investment management are outside the budget process, a distinction approved by the Office of the Budget in 1983. Nonetheless, the Board's ability to invest in staff (including investment staff), technology and other resources is subject to constraints based on considerations external to SERS. So long as the Board's decisions regarding expenses to be paid from SERS' assets are treated as fiduciary acts, subject to the standards of conduct applicable to investment decisions, there is no need to impose the Commonwealth-wide budget process on SERS. See UMPERSA Secs. 5(a) and (b).¹²⁷

¹²⁶ We are advised that SERS also makes a budget submission, but that it tracks the Governor's budget.

¹²⁷ The Official Comment to the cited section of UMPERSA states, "This section is intended to ensure that retirement system trustees have a level of independence sufficient to permit them to perform their duties and to do so effectively and efficiently. Trustees are different from other state actors because they are subject to an extensive and stringent set of fiduciary obligations to retirement system participants and beneficiaries. These obligations both require and justify some level of trustee independence."

Recommendation IC-5	SERS Response
<p><i>The Board should support legislation to grant the Board autonomy in establishing its administrative budget to be paid from SERS' assets, provided that such legislation makes it clear that the Board's decisions regarding expenses to be paid from the assets are subject to a rigorous standard of fiduciary responsibility, including a duty of prudence and a duty to act for the exclusive benefit of SERS' members.</i></p>	<p>CONCUR: The Board will evaluate options available that would enhance the autonomy in decisions relative to budget, procurement and compensations.</p>

b. Selection of Custodian

The Retirement Code provides, "The State Treasurer shall be the custodian of the fund."¹²⁸ In practice this not uncommon statutory authority has resulted in the State Treasurer selecting and contracting with the custody bank on behalf of SERS and other of the Commonwealth's investing entities. It is the Treasurer that selected and contracted with the System's custody bank, Mellon Bank, N.A. SERS was one of seven agencies whose assets were covered by the November 2, 1998 master custodial agreement between the Treasurer and Mellon, and four more agencies were added by subsequent amendment. SERS cannot terminate the contract with Mellon, and a decision by the Treasurer to terminate the contract with Mellon and enter into a custody relationship with a different bank would be binding on SERS.

The custody function involves much more than the safekeeping and accounting for SERS' assets. For example, the custody bank provides securities lending, proxy voting support, transaction settlement and reporting services that are critical to the System's functioning. The custody bank typically maintains the official book of record that provides information on transactions and holdings critical to reporting and litigation support activities. Deficiencies in the quality of such services and/or disruptions in the continuity of such records could adversely

¹²⁸ Retirement Code Sec. 5931(c).

impact the System operationally and functionally. In addition, the process of transitioning from one custodian to another is complex, costly (in terms of both time and money) and can be disruptive to the investment and reporting process.

To the Treasurer's credit, we understand that Mellon was selected through a competitive RFP process. Furthermore, Mellon is one of a small number of "top-tier" global custody banks able to provide a wide range of high quality custody services to large, complex institutional investment funds. We understand that State Treasurers have not historically made frequent or ill-informed changes in the custody relationship. In addition, the current contractual custody arrangement is uncommon and advantageous given the low flat fee of \$500,000 for all the funds included in the contract. Without the Treasurer's involvement and influence in the process, it is unlikely that a single fund even of SERS' size could obtain a contract with a fee as low as SERS' pro rata allocation of the state-wide contract, and impossible that the smaller, non-pension systems could enjoy that attractive pricing.

Notwithstanding that track record, from a governance perspective, it is less than optimal for the authority to select and terminate the custody bank to reside with a single elected official, without at least some degree of binding involvement by the SERS Board, which is bound to a rigorous fiduciary standard of care and a duty of loyalty to the SERS members. A legal and operational structure that provides to both the SERS and PSERS Boards at least a significant and influential role in deciding whether to change custody banks and who to select, combined with the ability to include the smaller state entities, would be ideal. This might involve SERS and PSERS selecting a custody bank together and allowing other Pennsylvania systems to participate in a beneficial group contract, with either direct involvement, indirect involvement, or informed consent from the Treasurer.

Recommendation IC-6	SERS Response
<p><i>The Board should support legislation to grant the Board authority to select and contract with the financial institution that will provide master custody services to SERS. Such legislation could require that the Board select the custodian from a list of institutions approved by the State Treasurer. Pending the enactment of such legislation, Board and the State Treasurer should collaborate in establishing a mechanism whereby the SERS Board and staff can provide to the State Treasurer meaningful input into significant issues related to the master custody relationship including:</i></p> <ul style="list-style-type: none"> <i>• the review of the performance of the custodian,</i> <i>• possible enhancements to the services provided by the custodian,</i> <i>• any decision to replace the custodian,</i> <i>• development of the scope of services to be provided by any new custodian and</i> <i>• the selection of a new custodian</i> 	<p>WILL CONSIDER: As noted, staff currently provides input and suggestions into the existing process and was involved in recent contract negotiations. The Treasurer has historically been sensitive and responsive to the needs of the Fund. As noted in the IFS report on page 113 “while it is optimal from a governance perspective for the Fund to have control over the selection of its custodian, the custodial arrangement in Pennsylvania is uncommon and advantageous.” We concur. This structure allows the state to use significant negotiating leverage for the delivery of custodial services at what IFS notes as “a very attractive fee arrangement.”</p>

c. Procurement and Personnel Processes

This is another area in which the autonomy of the Board is compromised by mandatory procedures which give the executive branch of the Commonwealth government significant control over the administration of SERS.

More generally, the procurement of goods and services other than investment management services is subject to the Commonwealth’s complex Procurement Code and the procedures it prescribes. All SERS RFPs must be submitted to the Central Services Comptroller and the Department of General Services, agencies of the Executive Branch, for review. The delays resulting from this process have affected SERS’ ability to acquire on a timely basis

Bloomberg portfolio monitoring systems which enhance staff's ability to manage the System's assets.

IFS recognizes that procurement policies should assure that goods and services are acquired on the basis of competitive bids, and that procurement decisions must be made on their merits, goals which the procurement process promotes. That having been said, our interviews with staff indicate that SERS is fully capable of administering such a process autonomously, and that the involvement of the executive branch in the process is by no means essential to the integrity of the process.

Many of these observations also apply to personnel decisions. The Governor's Office of the Budget must approve any expansion of SERS' staff. This has impaired SERS' ability to remedy staff shortages. The Bureau of State Employment, a part of the Office of Administration, can decide whether to permit SERS to recruit investment professionals from outside the Commonwealth workforce. As explained above, the Office of the General Counsel has final say over performance evaluations of the Chief Counsel and Assistant Counsels, and decides their compensation. The Board does have autonomy over certain aspects of the personnel policies at SERS, however. The Board has approved compensation increases for investment staff in the face of a general pay freeze. However the Office of Administration blocked implementation of a salary increase for the Executive Director (who has responsibility for the day to day operations of SERS, including the operations of the investment staff) which the SERS Board had approved. And the Office of Administration also conducted its own review of changes to SERS classification and pay structure, which could not be implemented unless and until the Office of Administration approved it.

When the involvement with procurement and personnel practices is combined with the influence of the Governor's office over SERS through its control of SERS' Chief Counsel and SERS' budget process, it is only natural that more than one key interviewee thinks of SERS as "under the Governor's jurisdiction" rather than as an autonomous board. SERS staff has not

identified to IFS any specific services, which the Office of Administration provides, that outweigh the disadvantages associated with the Office's involvement in SERS procurement and personnel issues.

Recommendation IC-7	SERS Response
<i>The Board should support legislation to grant the Board autonomy in procurement and personnel policies, provided that such legislation makes it clear that the Board's decisions regarding expenses to be paid from the assets are subject to a rigorous standard of fiduciary responsibility, including a duty of prudence and a duty to act for the exclusive benefit of the SERS members.</i>	WILL CONSIDER: The Board will consider pursuing limited, judicious autonomy where it can be proven to improve the System's governance.

4. Ethics

The management of a public pension fund requires that the fund's trustees inspire the highest degree of confidence from the beneficiaries of the funds and the public in general. The obligation of every board member and employee is to conduct himself or herself with the utmost, integrity, professionalism and ethical behavior. Public retirement systems should be governed by ethical standards which ensure – in fact and appearance – the proper administration, effective operation and prudence of pension fund investments pursuant to objective judgments, uninfluenced by conflicts of interest. Proper and consistent implementation of the standards requires that written policies and procedures be in place to monitor and guard against potential and actual violations.

The absence of properly rigorous ethics standards and procedures jeopardizes confidence in the integrity of the decisions made by the trustees, and permits those decisions to be influenced improperly. On the other hand, overly restrictive and complex ethics rules render compliance difficult and can entrap the unsuspecting.

***The Ethics Rules Applicable to SERS'
Board could be Enhanced***

According to a memorandum furnished to us entitled, “Ethics and Fiduciary Requirements Affecting Board Members,” dated March 10, 2004, various members of the Board are subject to several layers of standards of ethical conduct. First, the Board and its members (including designees) are subject to the Public Official and Employee Ethics Act (the “Ethics Act”). Second, Board members other than the Treasurer and the Legislative members (and their designees) are subject to the Governor’s Code of Conduct.¹²⁹ Third, Legislative members of the Board are subject to the Legislative Code of Ethics.¹³⁰

Many of these provisions (i.e., the Ethics Act, the Governor’s Code of Conduct, and the Legislative Code) contain overlapping or cumulative provisions on the same subjects. The fact that the Governor’s Code of Conduct only applies to some members of the Board while the Legislative Code applies to others creates distinctions among Board members which, as a matter of policy do not make sense. For example, the Ethics Act only (i) bars Board members from accepting gifts given with the understanding that the Board member will be influenced by the gift in his or her official actions, and (ii) requires that gifts in excess of \$250 be reported. The Governor’s Code of Conduct, on the other hand, bars acceptance of gifts from anyone doing or seeking business with the Commonwealth, regardless of the existence of any understanding, and requires the reporting of all gifts in excess of \$100. There seems to be no policy reason to exempt some Board members from the more restrictive requirements of the Governor’s Code of Conduct. While we understand that separation of powers principles might render it inappropriate to require legislators and the Treasurer to file financial disclosure reports with the Secretary of Administration pursuant to the Governor’s Code of Conduct, the Board could require that filings be made with the Board by all Board members and their designees.

¹²⁹ 4 Pa. Code §§ 7.151-159, 161-164, 171-179.

¹³⁰ 46 Pa. Code §§ 143.1 *et seq.*

Recommendation IC-8	SERS Response
<p><i>The Board should review on a comparative basis the Governor’s Code of Conduct and the Ethics Act and adopt rules incorporating the most stringent aspects of them to assure that all Board members are covered by the same requirements with respect to both conduct and disclosure. The rules should explicitly require that all designees comply with their requirements for so long as they are designees.</i></p>	<p>WILL CONSIDER: To provide background for the Board, staff will obtain information from other retirement systems.</p>

The substantive rules and reporting requirements imposed by the Ethics Act, the Legislative Code of Ethics and the Governor’s Code of Conduct are consistent with the types of rules imposed by the ethics laws of other jurisdictions. The Ethics Act defines a “conflict of interest” in terms of the use of a public official’s authority or confidential information “for the private pecuniary benefit of himself, a member of his immediate family or a business with which he or a member of his immediate family is associated, a formulation which, given how key terms are defined in the Ethics Act, is typical. The gift provisions in the Governor’s Code of Conduct are, as indicated above, more restrictive than the corresponding provisions in the Ethics Act, and, in IFS’ view, are more appropriate. Tying the gift restriction to the existence of an “understanding,” as the Ethics Act does, creates a difficult standard to enforce and ignores the fact that certain transactions create an appearance of impropriety regardless of whether an illicit understanding motivated the gift.

SERS Has not Adopted a Formal Policy on Board Member Travel

SERS has not adopted formal travel and expense reimbursement policies applicable to Board members, although Board members are bound by the Governor’s Office’s Management Directive 230.10 on Travel and Subsistence Allowances (the “Management Directive”).¹³¹ The

¹³¹ SERS requested, and was granted, an exemption from the Management Directive’s requirement to obtain advance authorization for out of state travel. SERS understands that the Board’s Legislative members are bound to the Management Directive in the same way as the rest of the Board.

Management Directive contains extensive procedural rules for obtaining reimbursement of travel expenses. However, the absence of a formal travel policy means there are no written rules identifying the types or frequency of trips which Board members may take at the expense of SERS or the procedures for obtaining approval for such trips.

The adoption and enforcement of such policies has become typical of retirement systems similar to SERS¹³² and such policies can mitigate both the appearance and the reality of abuse by Board members, while still providing opportunities for Board members to obtain education and training at quality programs which will enhance their ability to carry out their fiduciary responsibilities. Attendance at appropriate educational conferences can be beneficial to Board members, especially those with little to no investment experience, but it is our understanding that few, if any, SERS Board members travel to out-of-state educational conferences. The absence of a policy may lead Board members to conclude that they should not travel at all or risk disapproval.

Key elements of a travel policy would include:

- Requiring prior Board approval for all out-of-state travel.
- Enumeration of expenses eligible for reimbursement, and items not eligible for reimbursement.
- Requiring submission of receipts for all expenses.
- Barring receipt of reimbursement from sources other than SERS unless, with Board approval, the Board member is attending the conference as a speaker at the

¹³² See, December, 2003 National Association of State Retirement Administrators Survey of Board Travel Policies, available on the website of the National Council on Teacher Retirement, <http://nctr.org/pdf/boardtravelpolicies.pdf>

invitation of the organization sponsoring the conference (so long as the sponsor is not a current or prospective service provider to SERS).

- Requiring Board members to report the highlights of educational conferences to the full Board, and to make conference materials available to all Board members.

Recommendation IC-9	SERS Response
<i>The Board should adopt and implement a Board Member Travel Policy.</i>	WILL CONSIDER: The staff will prepare a policy statement for Board consideration.

5. Pay to Play

SERS has not Adopted a “Pay to Play” Rule

Every member of the SERS Board is an elected official or the appointee of an elected official (and, in the case of the legislative members, elected officials appointed by other elected officials). In addition, one elected official, the Governor, appoints, subject to Senate approval, a majority of the Board and exercises control over numerous aspects of SERS’ administration. In a system of private financing of political campaigns, a potential for abuse arises when persons or firms seeking to do or to continue to do business with SERS can make political contributions to those who have the ability to serve on or to name those who serve on the SERS Board, a practice known as “pay to play.” While Pennsylvania law requires candidates for public office to file public disclosure of campaign contributions, there is no rule which actually bars “pay to play” practices. SERS’ standard form of investment management agreement includes a provision requiring that the manager disclose all payments of “finders fees” associated with procuring the agreement with SERS. The Commonwealth Contract Provisions made part of each such contract

reference the statutory campaign contribution disclosure requirements¹³³ and bar payments of gratuities to Commonwealth officers and employees and pecuniary benefits in consideration for official action. It is also unclear whether there is a process in place for monitoring candidates' financial disclosure reports to confirm compliance with contract terms.

Recommendation IC-10	SERS Response
<i>The Board should adopt “pay to play” rules to require by contract, and in materials submitted with requests for proposals for services, that service providers and prospective service providers not make political contributions to any person who is a member of the Board, an official who appoints members of the Board, or to such a person’s political committee.</i>	WILL CONSIDER: To provide background for the Board, staff will obtain information from other retirement systems. Staff will also attempt to obtain information regarding the proposed SEC regulation cited by IFS that was not adopted and the reason for not adopting it.

One method for addressing the “pay to play” issue is the adoption of a policy identifying circumstances that require trustees to recuse themselves from certain discussions and decisions due to actual or apparent conflicts of interest. Section 1103(j) of the Ethics Act requires Board members to recuse themselves from voting “on a matter that would result in a conflict of interest” but the Ethics Act’s definition of “conflicts of interest” would not cover votes that would benefit a contributor to the political campaign of a Board member or a public official who appointed a Board member. We are not aware of a recusal policy specifically applicable to SERS Board members or designees, so each individual Board member or designee uses his or her own judgment to identify circumstances requiring recusal from a particular decision or issue.

¹³³ The statute referenced requires disclosure of certain campaign contributions by “[a]ny business entity. . . which has been awarded non-bid contracts by the Commonwealth or its political subdivisions. . . .” It is unclear whether SERS’s investment management contracts are “non-bid contracts” subject to the law.

Recommendation IC-11	SERS Response
<i>The Board should adopt a recusal policy identifying circumstances such as receipt of political contributions, outside financial interests, family relationships, etc. which would require a Board member or designee to recuse himself or herself from a particular discussion or decision.</i>	WILL CONSIDER: The Board has been following an informal recusal policy that complies with, and in some respects goes beyond, the conflict provisions of the Ethics Act. Staff will document and provide a formal policy for Board consideration.

Please see DAG's response at Exhibit G for comments on this section.

I-D. Investment Consultants' Responsibilities

1. Role of the General Investment Consultant

Most institutional investors employ an investment consultant to provide the Board with information, analysis and advice that enables the Board to make an independent assessment of the performance of the Fund's investment program. The role of the consultant has evolved to include advice regarding:

- Asset allocation;
- Investment policy;
- Investment structure and roles for investment managers;
- Manager selection;
- Account guidelines and compliance;
- Calculate investment returns;
- Compare those returns to benchmark returns and peer group performance;
- Calculate and monitor portfolio risks; and
- On-going manager monitoring and compliance

Consultants are also frequently called on to provide advice about custodial operations, trading and brokerage practices of investment managers, proxy voting, and the educational needs of the Board itself. Use of an independent investment consultant is considered a best practice.

One essential service provided by the consultant is a broad "field of vision." The consultant should be able to bring experience with a wide range of investment strategies, investment managers and fund performance, beyond the experience the Board and its own staff have and are able to achieve within the confines of their own investment program.

To be effective, the consultant's reports must be accurate, comprehensive and clear. The Board also needs to be able to have a very high degree of confidence in the advice and analysis of the consultant.

2. Review of SERS' General Consultant

Summary of the Services Provided by the Investment Consultant

SERS employs a general investment consulting firm, Rocaton Investment Advisors, to advise the Board on the structure of its investment program, on the selection of investment managers, and on the performance of the investment managers that serve SERS. The staff at Rocaton began their work for SERS in 1993 while employees of Rogers Casey. The consulting team at Rocaton left CRA Rogers Casey in 2002 and established their own independent firm. The consulting team assigned to SERS continued its work for the Fund throughout the transition from CRA Rogers Casey to Rocaton. The existing contract between Rocaton and SERS was renewed in 2005- for a term of two years.

The following table lists the services required in the contract between SERS and its general investment consultant and compares those required services with the services actually provided in practice to SERS by Rocaton.

Table I-D-1- Comparison of Consulting Services		
TYPICAL GENERAL CONSULTING SERVICES	SERVICE REQUIRED BY THE CONTRACT WITH SERS	SERVICE PROVIDED IN PRACTICE BY CONSULTANT
FIDUCIARY STATUS		
• Consultant acknowledges fiduciary status	✓	✓
• Consultant is a registered investment advisor	✓	✓

Table I-D-1- Comparison of Consulting Services		
TYPICAL GENERAL CONSULTING SERVICES	SERVICE REQUIRED BY THE CONTRACT WITH SERS	SERVICE PROVIDED IN PRACTICE BY CONSULTANT
ESSENTIAL SERVICES		
<i>Asset Allocation and Asset/Liability Studies</i>		
• Produce capital markets assumptions		✓
• Produce asset allocation study and recommendations	✓	✓
• Produce asset/liability report	✓	✓
<i>Investment Policy and Structure</i>		
• Prepare or review fund's Investment Policy Statement	✓	✓
• Review and recommend fund's investment structure	✓	✓
• Recommend performance benchmarks for asset classes and investment managers	✓	✓
<i>Periodic investment performance reports</i>		
• Produce investment performance reports	✓	✓
• Calculate investment rates of return for total fund and asset classes	✓	✓
• Calculate investment rates of return for external investment managers	✓	✓
• Rank fund and managers against appropriate peer universes	✓	✓
• Produce portfolio characteristics or risk analytics for each asset class	✓	
• Produce portfolio characteristics or risk analytics for each investment portfolio	✓	
• Reconcile return calculations with external managers		Consultant uses returns as provided by the custodian
• Monitor personnel, process and business issues at external managers		✓
<i>Selection of external investment managers</i> ¹³⁴		
• Recommend external investment managers	✓	✓
• Prepare profiles or analysis of recommended external managers	✓	✓

¹³⁴ Wilshire has not been retained by the Fund to provide services with respect to the selection of investment managers for the Fund's Developmental Program.

Table I-D-1- Comparison of Consulting Services		
TYPICAL GENERAL CONSULTING SERVICES	SERVICE REQUIRED BY THE CONTRACT WITH SERS	SERVICE PROVIDED IN PRACTICE BY CONSULTANT
<ul style="list-style-type: none"> Prepare guidelines for managers hired by Fund 		
Review of internal investment staff		
<ul style="list-style-type: none"> Review capabilities and structure of internal investment staff 	N.A.	N.A.
<ul style="list-style-type: none"> Track performance of internal investment staff 	N.A.	N.A.
Board Meetings, Education and Research		
<ul style="list-style-type: none"> Attend Board Meetings 	✓	✓
<ul style="list-style-type: none"> Advise on other investment subjects 	✓	✓
<ul style="list-style-type: none"> Conduct educational programs for Board and staff 	✓	✓
<ul style="list-style-type: none"> Provide research papers on investment topics 	✓	✓
COLLATERAL SERVICES (to be provided if requested by Fund)		
Real estate analysis or manager selection	N.A. Fund uses specialty consultant	N.A.
Hedge fund analysis or selection	✓	✓
Private equity analysis or selection	N.A. Fund uses specialty consultant	N.A.
Check compliance of external managers with Fund guidelines		
SECONDARY SERVICES		
Custodial evaluation or monitoring		
Securities lending analysis		
Brokerage analysis		
Commission recapture or brokerage discount analysis		
Advice on transition management services		✓
Advice on proxy voting policies		✓

b. Consultant's Responsibilities and Scope of Work

***The Investment Consultant Demonstrates
Appropriate Knowledge and Experience***

Good investment consulting advice requires consultants with broad and deep experience in the areas of capital markets behavior; asset allocation theory and practice; investment strategies, processes and techniques; brokerage practices; custody services; investment performance measurement; pension fund governance; and presentation skills.

IFS reviewed the investment consultant's asset allocation reports, asset/liability study, quarterly performance reports, and memos on investment issues and managers. We found the content of and analysis provided within these documents to be consistent with industry best practices. Our review of the investment consultant's work product and interviews with SERS staff indicate clearly and confirm that the consultant has substantial knowledge and experience regarding investment management, pension plan management, and the consulting services it provides to the Fund.

***The Consulting Services Provided by the
Investment Consultant are of High Quality***

By all accounts, SERS is a particularly challenging client for any consulting firm. SERS staff is very knowledgeable about capital markets, asset management techniques and alternative asset classes. Staff is eager to put this knowledge to work by pursuing innovative investment strategies and structures not typically seen in other major pension funds. Staff plays an equal role with the consultant on a range of functions such as asset allocation and manager selection. Staff actively seeks out information and data from a wide variety of sources, rather than relying on the consultant to be its sole source of perspective on financial markets. Staff does not hesitate to challenge the consultant's advice and to debate issues, from strategic policy to evaluations of

individual managers. Staff places significant demands on the consultant and is capable of critical review of the consultant's skills.

In this case, it is harder to assess the services provided by the consultant because staff plays such a strong role. It is difficult for an outside observer to determine where one party leaves off and the other begins. Both staff and the consultant report that their activities are closely intertwined and that decisions are frequently reached on the basis of consensus. However, both sides also note that there is substantial, robust debate on major issues, and that neither party is shy about expressing its opinion. At the end of the day, both staff and the consultant appear to relish and to benefit from this challenging interplay. Ultimately, both parties have a high regard for one another's work, suggesting that this intertwined relationship succeeds in providing the Fund with a high quality of advice and support for the investment process. IFS concludes that Rocaton's consulting services are of appropriate quality to meet the needs of SERS, are generally consistent with industry practices, and provide significant value to the Fund.

The Potential for Consultant Conflicts of Interest Exists

In May, 2005, the Office of Compliance Inspections and Examinations of the Securities and Exchange Commission released a staff report concerning the SEC's examination of a number of investment consultants.¹³⁵ The SEC described its analysis as follows:

Under the Investment Advisers Act of 1940 (Advisers Act), an investment adviser providing consulting services has a fiduciary duty to provide disinterested advice and disclose any material conflicts of interest to their clients. In this context, SEC staff examined the practices of advisers that provide pension consulting services to plan sponsors and trustees. These consulting services included assisting in determining the plan's investment

¹³⁵ A copy of the May 2005 SEC report on investment consultants can be found at www.sec.gov/news/studies/pensionexamstudy.pdf. Additional advice from the SEC on the selection of consultants can be found at www.sec.gov/investor/pubs/sponsortips.htm.

*objectives and restrictions, allocating plan assets, selecting money managers, choosing mutual fund options, tracking investment performance, and selecting other service providers. Many of the consultants also offered, directly or through an affiliate or subsidiary, products and services to money managers. Additionally, many of the consultants also offered, directly or through an affiliate or subsidiary, brokerage and money management services, often marketed to plans as a package of “bundled” services. The SEC examination staff concluded in its report that the business alliances among pension consultants and money managers can give rise to serious potential conflicts of interest under the Advisers Act that need to be monitored and disclosed to plan fiduciaries.*¹³⁶

The SEC examined in detail the practices of 24 major pension consulting firms who are registered investment advisers. The SEC found that:

- More than half of the firms provided services to both pension funds and investment managers.
- A significant number hold conferences that involve the participation of both pension fund clients and investment managers.
- Many sell the consulting firm’s performance evaluation software to investment managers.
- A majority is affiliated with broker-dealers, and they often receive payment for their consulting services based on the amount of client brokerage directed through the affiliated broker-dealer.

¹³⁶ “Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries”, first published by the SEC on June 1, 2005 at www.sec.gov/investor/pubs/sponsortips.htm.

- Many consultants do not consider themselves to serve their pension fund clients in the capacity of a fiduciary.
- Many do not maintain policies and procedures designed to prevent conflicts of interest and to disclose the nature of the consultants' other business relationships.

The SEC report reminded consultants that, under Rule 206(4)-7 of the Investment Advisers Act, consultants have an obligation to adopt policies and procedures to identify conflicts and compliance risks. The report suggested that consultants act to insulate their advisory activities from other business activities, to disclose all business relationships to their consulting clients, and to prevent conflicts associated with brokerage activities or gifts and entertainment given to clients.

Rocaton Investment Advisors does not provide services, software or analysis to investment management or financial services organizations, and therefore Rocaton is not subject to the potential for conflicts of interest as identified by the SEC. SERS, however, requires Rocaton (and its other consultants) to file disclosure reports annually. This effort to obtain disclosure and to review reports from its consultants constitutes a best practice on the part of the Fund. Rocaton does disclose to the Fund that it serves as investment consultant to the retirement plans of some major financial services firms, but this does not appear to pose any conflict of interest (and Rocaton's disclosure appears to be adequate).

Recommendation ID-1	SERS Response
<i>Given the growing importance of managing any potential conflicts, the Fund should seek to amend its contract with Rocaton to include annual disclosure as a contractual requirement.</i>	CONCUR: Rocaton currently includes all the suggested disclosures in its quarterly reporting. Nevertheless, staff will seek to amend the contract as recommended.

3. Role of the Real Estate Consultant

Real estate is a complex asset class that involves unique risks and opportunities. The skills required to advise the Fund in this asset class typically go beyond those offered by most general investment consultants or in-house fund staff. Boards need specialist advice to set policy, select investments and monitor results. For a real estate program of any size or complexity, the absence of a real estate consultant increases the likelihood that the Fund will fail to achieve the investment returns it seeks from this asset class.

Many large institutional investors employ a specialist consultant to advise the Board on investment strategies and opportunities in real estate. These assignments can take a variety of forms, some with discretion to make investments on behalf of the client, while others may only provide advice to decision makers (Board or staff) at the Fund. The traditional distinction between investment consultant and investment manager seen in the worlds of publicly traded investments (like stocks and bonds) is often less clear in real estate because the consultant sometimes performs duties that more closely resemble those of a discretionary asset manager. The distinction is further blurred depending on the extent to which the Fund itself employs staff with significant skills in real estate acquisition and management. Some consultants work closely with Fund staff to implement a real estate plan. Others focus on advising the Board on the selection of discretionary real estate managers and calculation of investment rates of return.

Generally, the real estate consultant will advise the Board on:

- Market conditions;
- Strategy and investment policy;
- Investment structure and roles for managers;

- Manager or real estate Fund selection;
- Manager guidelines;
- Preparation of an investment performance report;
- Portfolio risks; and
- On-going manager monitoring and compliance.

To the extent that the consultant also has the discretion to select specific properties for purchase by the Fund, the consultant will take responsibility for:

- Sourcing potential investments;
- Evaluating the extent to which a specific investment meets the Fund's requirements or guidelines;
- Due diligence on the property under consideration, including review of financial data, evaluation of tenancy and leasing, and visits to the property;
- Negotiation with the seller;
- Closing the transaction;
- Selection of property manager, leasing agent, maintenance firms and other service providers;

- Preparation of regular reports on the property;
- Capital budgeting and improvements; and
- Disposition of properties when market circumstances or Fund needs so warrant.

To the extent that the real estate consultant recommends specific investments or vehicles for the Fund, it should serve the Fund as an investment fiduciary. If the consultant does not serve in the capacity of a fiduciary, a Fund risks that its investment portfolio may not be managed to the highest standard of duty and care. For public pension funds like SERS with over \$500 million in real estate assets and a sophisticated program that combines direct holdings with pooled Fund vehicles, use of a real estate consultant is considered a best practice.

4. Review of SERS Real Estate Consultant

Summary of the Services Provided by the Real Estate Consultant

Townsend reports that it has worked for SERS for ten years. The following table lists the services required in the 2004 contract between SERS and The Townsend Group and compares those services to those actually provided in practice to SERS by Townsend.

Table I-D-2- Comparison of Real Estate Consulting Services			
	Standard Services Provided by RE Consultants	Required in Townsend Contract	Provided by Townsend in Practice
Capabilities			
Serves as an investment manager ¹³⁷	Depends on role assigned by client		
Serves as a fiduciary	✓	✓	✓
Develop Overall Real Estate Strategy			
• Develop Strategic Plan, including:	✓	✓	✓

¹³⁷ Townsend does not manage directly any properties on behalf of the Fund.

Table I-D-2- Comparison of Real Estate Consulting Services			
	Standard Services Provided by RE Consultants	Required in Townsend Contract	Provided by Townsend in Practice
<ul style="list-style-type: none"> ○ Benchmarks ○ Core investments ○ Non-core investments ○ Investment types ○ Investment vehicles ○ Liquidity required ○ Legal constraints ○ Investment approval process 			
• Develop Investment Plan (to implement the Strategic Plan)	✓	✓	✓
Separate Account Manager Guidelines	Where Appropriate		
• Prepare guidelines	✓	✓	✓
• Determine benchmarks	✓	✓	✓
• Modify guidelines	✓	✓	✓
• Handle exceptions	✓	✓	✓
Separate Account and Pooled Fund Manager Selection	Where Appropriate		
• Recommend changes to real estate manager mix	✓	✓	✓
• Design search criteria	✓	✓	✓
• Conduct due diligence	✓	✓	✓
• Recommend finalists	✓	✓	✓
• Assist in preparation of legal documentation	✓		
• Oversee Funding or capital calls	✓		
Monitor Investment Managers			
▪ Review Budget and Management Plan for each manager	✓	✓	✓
▪ Conduct annual meeting with each manager	✓		✓
▪ Prepare annual written evaluation of each manager	✓	✓	✓
▪ Evaluate manager's adherence to Fund's investment guidelines	✓	✓	✓
▪ Evaluate managers' compliance with managers' own investment philosophy and process	✓		✓
▪ Review managers' performance measurement and reporting	✓		✓
▪ Monitor each manager's stability of personnel and organization	✓		✓
▪ Review regular manager reports	✓		✓
Monitor Fund's Real Estate Strategy and Program			
▪ Conduct annual review of real estate portfolio	✓	✓	✓

Table I-D-2- Comparison of Real Estate Consulting Services			
	Standard Services Provided by RE Consultants	Required in Townsend Contract	Provided by Townsend in Practice
▪ Report on general economic conditions affecting real estate market	✓	✓	✓
▪ Monitor and analyze performance	✓	✓	✓
Acquisition of Direct Property Investments (in those cases where the client retains the consultant to provide advice and oversight of program)¹³⁸	Where Appropriate		
• Evaluate whether proposed acquisition meets Fund's requirements	✓		
• Source investment opportunities	✓		
• Conduct due diligence, including <ul style="list-style-type: none"> ○ Market analysis ○ Physical/property analysis ○ Regulatory/compliance analysis ○ Tenant analysis ○ Financial analysis ○ Risk analysis ○ Transaction analysis ○ Unrelated Business Income Tax (UBIT) analysis 	✓		
• Conduct on-site inspection	✓		
• Close transaction	✓		
Management of Direct Holdings (in those cases where the client retains the consultant to manage specific holdings)¹³⁹	Where Appropriate		
• Oversee portfolio and asset management responsibilities	✓		✓
• Develop portfolio management strategies	✓		✓
• Select and oversee service providers (property manager, building services, etc.)	✓		
• Oversee budgets, leasing, financing, maintenance, and renovation	✓		✓
• Manage appraisals for core properties	✓	✓	✓
• Select appraisers	✓	✓	✓
• Recommend disposition	✓		
• Manage sales process	✓		
Performance Measurement			
▪ Collects and consolidates returns and market values from managers	✓	✓	✓
▪ Reconciles accounting and transaction data with custodian	✓		✓

¹³⁸ Townsend has not been retained to provide these services to the Fund.

¹³⁹ Townsend has not been retained to provide these services to the Fund.

Table I-D-2- Comparison of Real Estate Consulting Services			
	Standard Services Provided by RE Consultants	Required in Townsend Contract	Provided by Townsend in Practice
▪ Produces quarterly investment performance reports for Board	✓	✓	✓
Other Functions			
• Prepare Board meeting materials	✓	✓	✓
• Present material to Board	✓		✓
• Conduct seminars or educational efforts for Board/staff	✓	✓	✓
• Conduct miscellaneous research studies	✓	✓	✓

The Investment Consultant Demonstrates Appropriate Knowledge and Experience

Townsend is widely recognized as one of the most capable real estate consulting firms in the U.S. serving institutional investors. It is employed by a range of major pension funds, many with billions in real estate holdings, and by a number of large public pension funds. Townsend's staff is highly experienced, its organization is stable, its database of real estate investments is substantial, and its reports to clients are comprehensive.

The Consulting Services Provided by the Investment Consultant are of High Quality

Our review of Townsend's consulting advice to the Fund indicates that the services it provides are thorough and complete. Townsend appears to provide more services than are specifically required in its contract with the Fund, but these services are consistent with a "full-service" specialist consultant (operating in this asset class).

Townsend's work for the Fund and the procedures it employs are well-documented. This work product creates a sound foundation on which the Board can make investment decisions.

The Board and staff report that they are very satisfied with the quality of the advice received from Townsend.

Recommendation

No recommendation necessary.

5. Role of the Private Equity Consultant

Like real estate, private equity is an asset class that is often used by large institutional funds and one that differs markedly from publicly traded assets like stocks and bonds. Both private equity and real estate are relatively illiquid assets that are complicated to acquire and to sell. Once invested, an owner cannot exit easily, and when an asset fails to meet expectations, the investor may find it necessary to become more directly involved in management of the underlying business. Private equity, venture capital and private debt offer the potential for substantial returns, but with the likelihood of greater risk. In any event, such investments are relatively labor-intensive from the investor's point of view.

For funds of virtually any size with a small private equity allocation, use of a general investment consultant for advice on private equity represents a best practice. To the extent that a fund's program extends beyond use of a few fund-of-fund vehicles, use of a private equity or alternatives specialist represents a best practice.

Private equity consultants provide more in-depth knowledge of the workings of private markets, possess up to date information on managers and funds, and can deliver access to investment vehicles that would otherwise be unavailable to the investor. Although the content is different, the types of services and advice they offer to investors resemble that of general investment and real estate consultants. Essential services by a private equity specialist include:

- Development of an overall strategy for investment in the asset class;

- Creation of an investment policy that guides the Fund's efforts;
- Advice about how to structure an appropriate blend of leverage buy-outs, venture capital, mezzanine debt financings, secondary funds, distressed debt, private debt, and other private assets;
- Advice about the selection of limited partnerships, sector-specific funds, and fund-of-fund vehicles;
- Due diligence on the most appropriate candidates for investment;
- Identification and evaluation of specific managers and partnerships;
- Assistance in negotiating advantageous terms when making an investment;
- Monitoring the portfolios and operations of those managers selected by the fund;
- Construction of benchmarks or indexes for comparison to manager returns;
- Performance reporting and calculation of investment returns; and
- Documenting the procedures employed by the client in this asset class.

Other common services may include:

- Longer-range planning for the client's program;

- Accounting for cash flows into and out of the investment vehicles;
- Access to the consultant's database of manager and partnership returns;
- Research on general topics in the field;
- Preparation of educational materials and presentations for the Board;
- Participation on the advisory boards associated with many partnerships or managers;
- Arranging for background checks on managers; and
- Responsibility for "discretionary" management of investments or for provision of a fund-of-funds vehicle.

Depending on the role of a fund's own investment staff, the specialist consultant may provide some of these additional services.

6. Review of SERS Private Equity Consultant

Summary of the Services Provided by the Private Equity Consultant

SERS employs Cambridge Associates as its specialist consultant regarding private equity and venture capital. Cambridge first started working for SERS eleven years ago. Cambridge serves the Fund as a non-discretionary advisor; that is, it makes recommendations on private equity funds, but the ultimate decision on limited partnership investments is made by the SERS Board. Cambridge's contract with the Fund is very detailed with respect to the services the

consultant provides. This list of services is thorough and comprehensive, and it is consistent with the services we consider to be essential in this asset class. Cambridge provides advice on:

- Investment policy and objectives;
- Guidelines for specific investments;
- Preparation of both an annual investment plan and a five year plan;
- Development of appropriate benchmarks against which to compare the returns achieved by the Fund and each of the private equity partnerships in which the Fund invests;
- Allocation among sub-sectors within the alternatives asset class;
- Rebalancing between sub-sectors and partnerships when necessary or possible;
- Identification of the most appropriate investment managers and partnerships;
- Due diligence on managers and partnerships;
- Analysis of investment performance of those candidates for investment;
- Preparation of reports to the Board that recommend specific investments;
- Review of business terms and conditions of those partnerships in which the Fund seeks to invest; and

- Maintenance of a database of partnership cash flows, investment returns and financial information.

The consultant also prepares semi-annual reports on the Fund's investments for review by the Board. These reports compare the returns of the Fund's investments with appropriate benchmarks. Cambridge provides the Fund with research, conducts educational sessions for the Board and staff, and attends all Board meetings.

***The Private Equity Consultant Demonstrates
Appropriate Knowledge and Experience***

IFS reviewed examples of the private equity consultant's reports and recommendations, reports on specific investment opportunities, and regular investment performance report. The consultant's work was thorough and addressed the major issues involved in the portfolio and in individual investments. We found the content of and analysis provided within these documents to be consistent with industry best practices.

Our review of the investment consultant's work product and interviews with SERS' staff confirm that the consultant has substantial knowledge and experience regarding investment management.

***The Consulting Services Provided by the
Private Equity Consultant are Consistent
with the Needs of SERS***

Our interviews with the Board, staff and the consultant indicate that the services specified in the contract are being provided in practice. Staff and the consultant work closely together on the evaluation of candidates for new investment, on the determination whether or not to make follow-on investments with incumbent managers, and on monitoring the total alternative investment portfolio of private assets. Although staff and the consultant have disagreed on

occasion, staff and the consultant generally reach consensus on any recommendation to be taken to the Board. Staff reports a high degree of satisfaction with the work of the consultant.

Recommendation
<i>No recommendation necessary.</i>

Please see DAG's response at Exhibit G for comments on this section.

I-E. Securities Litigation Activities

1. Background

Pension funds across the country are increasingly being asked to lead, or become significantly involved in, securities action litigation resulting from corporate fraud and other wrongdoing. This is driven by many factors, including Congress' stated intent, when adopting the Private Securities Litigation Reform Act of 1995 (PSLRA), concluding that institutional investors are best suited to control these types of lawsuits.¹⁴⁰ A NERA¹⁴¹ study of securities class action filings, settlements and investor losses in 2004 found that securities class action filings against WorldCom, Raytheon and Bristol-Myers Squibb produced three of the eight largest class action settlements of all time – with a combined value of over \$3.3 billion. These settlements contributed to a 33% increase in the mean settlement amount – \$27.1 million in 2004 versus \$20.3 million in 2003. Of the 119 settlements made in 2003 only nine were valued at \$100 million or more; 16 settlements exceeded \$50 million. Over 70% of settlements were valued at \$10 million or less and over 44% of settlements fell under \$5 million.¹⁴²

Securities Class Action Claims are Plan Assets

Trustees have a fiduciary duty to invest and manage plan assets prudently. Securities class action litigation affects investment returns. It affords the opportunity to recover losses

¹⁴⁰ “The Conference Committee believes that increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions. Institutional investors are America’s largest shareholders, with about \$9.5 trillion in assets, accounting for 51% of the equity market. According to one representative of institutional investors, “as the largest shareholders in most companies, we are the ones who have the most to gain from meritorious securities litigation.” H.R. Conf. Rep. No. 104-369, at 34 (1995). See also, *In re Horizon/CMS Healthcare Corp.*, 3 F.Supp.2d 1208, 1212 (D.N.M. 1998), where the judge stated that the PSLRA “appears to reflect a congressional intent to transfer power from counsel who win the race to the courthouse to those shareholders who possess a sufficient financial interest in the outcome to maintain some supervisory responsibility over both the litigation and their counsel.”

¹⁴¹ National Economic Research Associates, Inc., a subsidiary of Mercer Inc., a Marsh & McLennan Company, is an international firm of economists which provides economic analysis and advice to corporations, governments, law firms, regulatory agencies, trade associations, and international agencies. NERA has more than 500 professionals and operates in 20 offices across North and South America, Europe, Asia, and Australia.

¹⁴² NERA Economic Consulting report, “Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements,” February, 2005.

resulting from the wrongful actions of a company in which pension fund assets are or were invested. The Department of Labor (DOL) views securities class action claims as plan assets. Since the claims are plan assets, DOL has advised ERISA funds that trustees have *an affirmative duty to determine whether it would be in the best interest of plan participants to become actively involved* in securities litigation, and a duty to take reasonable steps to realize on claims.¹⁴³ DOL's reasoning was based on common law trust principles. The trustees' duties extend to actively monitoring situations where "the activities of the plan alone, or together with other shareholders, are likely to enhance the value of the plan's investment, after taking into account the costs involved."¹⁴⁴ This analysis is critical because a fund that assumes a lead plaintiff role in a federal securities class action has a fiduciary responsibility to the class to monitor the litigation for the benefit of all eligible class members. Consequently, the fund will be obligated to devote the necessary resources to the litigation, which will include time, expenses and effort. The NERA statistics regarding the value of settlements demonstrate why a cost/benefit analysis is imperative.

***Public Pension Funds Investing in Domestic Equities
are Almost Certain to Be Affected by Securities Class Actions***

Although public pension funds are not subject to ERISA, most are governed by fiduciary standards that are similar, if not identical, to ERISA principles. It is probable that courts will take ERISA principles into account when construing whether public pension fund trustees have an affirmative duty regarding securities class action claims. Consequently, it is advisable for public pension fund trustees to address how they are going to meet their fiduciary responsibility in this area.

***Trustees Should Adopt a Formal Securities
Class Action Litigation Policy***

¹⁴³ DOL *amicus* brief submitted in *Bragdon v. Telxon Corp.*, 98 Civ. 2876 (N.D. Ohio April 28, 1999).

¹⁴⁴ Interpretive Bulletins Relating to ERISA, 59 Fed. Reg. 38,860, 38,860-61(1994).

To address its fiduciary responsibility, and to take reasonable steps to identify and recover securities class action claims, boards of trustees should adopt a formal securities litigation policy. The policy should (a) acknowledge that securities class action claims, arising out of misdeeds which caused losses to the pension fund, are plan assets and therefore the trustees have a fiduciary duty to take reasonable, cost-effective, steps to identify, analyze, pursue, and collect securities class action claims; (b) identify the objectives of the board in pursuing securities litigation; (c) set forth the evaluation and monitoring process that will be used; (d) identify a minimum loss threshold; and (e) define the roles and authority of the key parties in the process.

***Fiduciaries Have a Duty to Consider
How Best to Pursue Claims***

The policy should establish the decision making framework and criteria for determining the nature and level of the pension fund's efforts to recover losses. The level and nature of a pension fund's participation may include:

- Participating as a passive class member in class actions brought by others and filing a proof of claim when the action is settled or otherwise resolved;
- Enhanced participation as a class member in class actions brought and led by others, by considering objections or comments on settlements;
- Active participation in class action litigation, including serving as a "lead plaintiff"; or
- Opting out and filing a separate lawsuit on behalf of the pension fund.

Examples of possible objectives the Board may have in pursuing claims include:

- Preservation of plan assets and collection of all amounts due to the pension fund;
- Maximizing the net recovery to the class; and
- The opportunity to effect corporate governance reforms as part of the securities litigation settlement.

***Pension Funds Should Adopt a Securities Litigation
Policy Implementation Protocol***

The securities litigation policy should be executed in accordance with a written implementation protocol. All actions should be documented and the parties responsible for each aspect of the policy should be specified. The policy should identify the key parties required to implement the policy and define their roles. Participants may include members of the SERS' legal, investment and audit staffs, external service providers, such as the custody bank and/or a monitoring service, and outside legal counsel.

Case Identification – The protocol should include the methodology to be used for *monitoring* the pension fund's portfolio and for identifying the universe of potential securities litigation settlements in which the fund may be a class member.

Responsibility for Case Identification: Staff and/or outside service provider (e.g., monitoring firm or a law firm). Some custody banks also have the capability to perform this function and may be used to perform this task

Case Evaluation – Phase I

- *Process to determine eligibility to participate in class* - review trading activity to determine whether the pension fund held shares during the “class period,”
- *Process to determine estimated value of potential claim* - use of a predetermined formula (such as used in the example below), and

Responsibility for Case Evaluation – Phase I: Staff or outside service provider (e.g., monitoring firm or a law firm). Some custody banks also have the capability to perform this function and may be used to perform this task.

The Protocol Should Establish the Pension Fund’s Decision-making Structure for Acting Upon the Information the Monitoring Firm and Evaluation Counsel Provide

Case Evaluation – Phase II – Based on the Phase I determination, if the loss calculation reveals that the minimum loss threshold is exceeded, or based on exceptional circumstances, a more in-depth evaluation is conducted. The criteria for determining the cost-benefit of active involvement should be predetermined. Typical criteria includes, but is not limited to:

- *Size of the pension fund’s losses*
- *Costs of Participation* – whether potential losses are significant enough to warrant expenditure of resources and whether participation will add value;
- *Quality of the Case* – whether the case raises meritorious claims which are likely to withstand a motion to dismiss;

- *Other Institutional Investors* – Qualifications of other lead plaintiff candidates and their counsel, and likelihood that pension fund would be selected a lead plaintiff; and
- *Likelihood of Recovery* – are there limits on the ability to recover (e.g., company has no insurance, is bankrupt, out of business)

Responsibility for Case Evaluation – Phase II: This function is typically performed by a law firm that is experienced in performing additional due diligence on claims (“Evaluation Counsel”)¹⁴⁵ or another external service provider. The function can also be performed internally, provided the pension fund legal staff has adequate resources and expertise.

During the Phase II evaluation process, a written analysis and recommendation should be prepared that identifies what the most cost effective options appear to be and the impact of the options.¹⁴⁶ This recommendation is then considered by the designated parties and a determination of whether and how to proceed is made. The protocol should identify the considerations relevant to deciding whether to pursue separate litigation or lead plaintiff status. These considerations may include:

- Size of the Fund’s damages measured by standards applicable to securities litigation;
- Strength of claims, including evaluation of defenses;

¹⁴⁵ Evaluation Counsel might also be the monitoring firm used to identify potential claims. Evaluation Counsel should be selected, using an RFP, based on experience, qualifications, information technology resources, evaluation process, references, malpractice history, insurance coverage, contract terms such as indemnification, and fee proposals, as well as whether the firm provides similar services to other institutional investors.

¹⁴⁶ Options include: doing nothing; opting out; seeking lead plaintiff status; seeking co-lead plaintiff status; active case monitoring; supporting the application of another investor for lead plaintiff; communicating with the court on specific issues; opposing the continuation of the class action; or filing an objection (e.g., to the terms of the settlement or attorneys fees).

- Special circumstances which render the pension fund's claims different from and/or stronger or weaker than claims of typical class members;
- Venue of litigation;
- Availability of resources to pay a significant recovery (e.g. financial condition of target company, availability of insurance, third party or other defendants such as auditors, underwriters, etc.);
- To the extent known, the qualifications of other lead plaintiff candidates and their counsel, and likelihood that the pension fund would be selected a lead plaintiff;
- Relation of claims to other corporate governance issues of special interest to the pension fund or its participants, and impact on other pension fund holdings;
- Potential for non-monetary remedies of special importance to the pension fund which other class members/lead plaintiffs may not pursue; and
- Costs to the pension fund of separate litigation/lead plaintiff status such as discovery, staff and Board time and resources needed to participate in and monitor litigation more actively.

Claims Management Process - A claim should be filed on behalf of the pension fund in connection with every securities class action litigation settlement in which the pension fund is a member of the class, unless the Board (or a Committee of the Board established for this purpose) determines, based on expert advice that it is in the interest of the Fund not to do so.

Responsibility: This function is typically performed by the custody bank but it may also be performed by a securities class action monitoring firm. The responsible party should accept fiduciary responsibility for filing proofs of claim for all settlements in which the pension fund is an eligible class member.

An effective claims management process – (a) assures that the responsible party has the list of pension fund claims over the threshold in order to consider whether to object/comment/opt out, and timely forwards proposed settlements of such claims to the designated party (e.g., evaluation counsel) for evaluation; (b) assures that claim payments are accurate; (c) provides that guidelines to custodian for investing and accounting for proceeds of claims; (d) provides for a claims reconciliation process and an internal audit process to check accuracy of claim filing activity;¹⁴⁷ and (e) requires that the pension fund's custodian to provide monthly report, with annual cumulative report, to the pension fund, for each notice of settlement received. The report should identify:

- Name of security, CUSIP number, and date notice of settlement is received,
- Class period for each notice,
- Due date for claim filing,
- Date claim filed,
- Identification of accounts to which proceeds will be credited,
- Date payment received and amount of payment, and

¹⁴⁷ The details of the securities litigation internal audit process should be set forth in a separate audit procedure.

- Distribution of proceeds for investment.

***The Pension Fund's Decision and
the Rationale Supporting it Should be Documented***

If it is determined that active involvement is warranted, the pension fund may file to become lead plaintiff. Typically internal legal counsel, after reviewing the report of external Evaluation Counsel (or if resources and expertise exist internally, the preparation of an evaluation report), makes a recommendation to the board of trustees (or a designated committee of the board) for their action. If the board votes to proceed, "Litigation Counsel" must then be selected to represent the pension fund,¹⁴⁸ and specific litigation strategy and a proposed budget must be developed that is in the best interest of the class.

Some pension funds, while acknowledging that they may have a fiduciary duty to pursue recovery on a claim, take into consideration that most claims will be prosecuted by the class action bar whether or not they take an active role. For this reason, they adopt a policy that provides for them to maintain a passive role unless there are exceptional circumstances that warrant an active role. Active involvement may be less than lead or co-lead plaintiff status, including for example (a) filing briefs or motions with the Court concerning the selection of lead plaintiff, lead counsel, or other litigation matters, (b) filing a notice of appearance and more actively monitoring the case, (c) participation in settlement negotiations or consulting with lead plaintiff or lead counsel on a proposed settlement. If it is determined that active involvement is not warranted, the pension fund must nevertheless continue to monitor the case through the proposed settlement/conclusion.

¹⁴⁸ A process and criteria used to select "Litigation Counsel" should consider the criteria listed for selection of evaluation counsel. To avoid any conflict regarding the objectivity of the advice given, some pension funds will not allow Evaluation Counsel to serve as Litigation Counsel in the same litigation matter.

2. Review of SERS' Current Securities Class Action Practices

Prior to May 24, 2006, SERS implemented its securities litigation program through a series of documents, commencing with SERS Resolution 2003-49. Among other things, the Resolution established a Securities Litigation Committee to serve as the decision-making body with respect to securities litigation matters. Implementation procedures for the securities litigation process were established in three primary procedural documents: 1) Proposed Steps in Securities Litigation Process for SERS, dated April 7, 2004; 2) Factors to Consider in Deciding Whether to seek Lead Plaintiff status in Securities Class Actions; and 3) the ARC Process for monitoring class action claims, dated April 20, 2005.

IFS reviewed, commented upon and made recommendations concerning the procedures described in these documents. During the drafting and review process, IFS recommended that SERS develop and adopt a formal, comprehensive securities litigation policy. We outlined the contours of such a policy and included recommended provisions. Among the salient points we raised were the following:

- Resolution 2003-49 failed to include a number of fundamental provisions typically found in securities litigation policies;
- The decision-making framework for determining if and when to pursue a litigation matter needed to be established in the written policy; and
- The policy needed to have a complete discussion of the roles and authority of the various participants in the implementation process.

Prior to finalization of this Report, SERS' General Counsel provided IFS with a copy of a new Securities Litigation Policy, which was approved by the SERS Board on May 24, 2006. We

were not asked to review the new Policy prior to its adoption. The Policy, moreover, is not part of the scope of IFS' review, since it was created after June 30, 2005.

Based on a preliminary review of the new Policy, however, it appears that SERS has addressed many of the concerns IFS raised in its initial review of the System's securities litigation program. Nonetheless, we have included our original comments on the SERS securities litigation program and, to the extent some of our recommendations have not been addressed in the new Policy, they are memorialized in this Report and are available for future consideration by SERS and the Board.

a. SERS' Securities Litigation Policy, as of June 30, 2005

The SERS securities litigation policy is in effect codified in SERS Resolution 2003-49, which was unanimously approved by the Board on June 4, 2003. Resolution 2003-49 is an expansion of SERS' approach to securities litigation previously established in Resolution 1998-67. Resolution 2003-49 established a Securities Litigation Committee and vested authority in the Securities Litigation Committee to (1) establish the general principles to be considered in determining whether SERS should participate in securities litigation and in what capacity (e.g., seek lead plaintiff or co-lead plaintiff status, opt-out and institute separate action);¹⁴⁹ (2) engage law firms to advise or represent SERS (e.g., to monitor cases, to serve as evaluation counsel or litigation counsel);¹⁵⁰ (3) coordinate efforts with other potential plaintiffs in order to achieve a better result for SERS; and (4) take other appropriate action as it deems necessary to exercise its powers and comply with applicable laws and regulations. Resolution 2003-49 also defines the

¹⁴⁹ It is important to note that SERS does not have the authority to actually initiate securities litigation cases. The Attorney General must either agree to undertake litigation or the Attorney General must authorize General Counsel to pursue such litigation.

¹⁵⁰ The law firms are selected from a list of qualified law firms established by SERS. SERS does not have independent authority to retain law firms. Law firms may only be retained by or with the approval of the Governor's Office of General Counsel.

minimum loss threshold.¹⁵¹ The Securities Litigation Committee is SERS' decision-making body with regard to securities litigation matters and its actions are not required to be approved by the Board. However, the Board can override actions of the Securities Litigation Committee.

Resolution 2003-49 Does Not Contain Many of the Fundamental Characteristics of a Formal Securities Litigation Policy

SERS Resolution 2003-49 does not:

- Acknowledge that securities litigation claims are plan assets;
- Reference the trustees' fiduciary duty to take reasonable, cost-effective steps to identify, analyze, pursue, and collect securities class action claims;
- Identify the objectives of the board of trustees in pursuing securities litigation;
- Set forth the evaluation and monitoring process that will be used;
- Describe the decision making framework and criteria for determining the nature and level of the pension fund's efforts to recover losses;
- Define the roles and authority of the key parties – internal and external (other than the Securities Litigation Committee); and
- Reference the “Factors to Consider in Deciding Whether to Seek Lead Plaintiff Status in Securities Class Actions” or “Proposed Steps in Securities Litigation Process for SERS.”¹⁵²

¹⁵¹ “Minimum loss threshold” is the amount of the pension fund's estimated loss that must be exceeded before further claim evaluation is warranted.

Based on extensive discussions with representatives from SERS it is clear to IFS that the staff and the Board are knowledgeable of the duties regarding securities class actions and have an extensive process in place to monitor, evaluate, and process claims. The process SERS follows has been articulated to us orally and in the form of a very detailed and informative flowchart. IFS also provided SERS' staff with model securities litigation policies for their review. Nevertheless, we strongly believe that a formal policy specifically addressing each of the items identified above is important, and would be reflective of the Board decision to take an active role in this area. The written policies of other public pension funds that are proactive regarding securities class action litigation tend to address each of these items. (e.g., SWIB, LACERA, CALPERS, and CALSTRS).

Recommendation IE-1	SERS Response
<p><i>We recommend that SERS adopt a formal securities litigation policy. The policy should (a) acknowledge that securities class action claims are plan assets (b) reference the Board's fiduciary duty to take reasonable, cost-effective, steps to identify, analyze, pursue, and collect securities class action claims, (c) identify the objectives of the Board in pursuing securities litigation, (d) set forth the evaluation and monitoring process that will be used, (e) describe the decision-making framework and criteria for determining the nature and level of the pension fund's efforts to recover losses, and (f) define the roles and authority of the key parties in the process (see Exhibit E – Sample of Key Parties Roles and Responsibilities).</i></p>	<p>CONCUR: A securities litigation policy incorporating IFS's recommendations was adopted by the Board at its meeting on May 31, 2006.</p>

¹⁵² These internal operating documents have been presented to and accepted by the Securities Litigation Committee as the operative approach to be used regarding SERS securities litigation.

b. SERS' Securities Litigation Process

The three primary procedural (as opposed to policy) documents which set forth SERS approach to securities litigation are: the April 7, 2004 "Proposed Steps in Securities Litigation Process for SERS" the "Factors to Consider in Deciding Whether to Seek Lead Plaintiff Status in Securities Class Actions"¹⁵³ and the ARC process for monitoring class action claims, dated April 20, 2005. These documents set forth the steps in the administration of the securities litigation process at SERS. The "Proposed Steps in Securities Litigation Process for SERS"¹⁵⁴; and the "Factors to Consider in Deciding Whether to Seek Lead Plaintiff Status in Securities Class Actions" have been presented to, reviewed, and accepted by the Securities Litigation Committee. However, the acceptance of these documents by the Securities Litigation Committee has not been memorialized by the adoption of a formal resolution. The documents are procedural in nature, for the purpose of implementing board policy. Therefore, one could argue that they do not have to be approved by the Securities Litigation Committee or Board. On the other hand, Resolution 2003-49 grants authority to the Securities Litigation Committee to establish the principles and process for consideration of whether and in what capacity SERS will participate in securities litigation. Further, the "Proposed Steps in Securities Litigation Process for SERS" was created in response to the Governor's Office of General Counsel and not at the request of the Securities Litigation Committee. The Securities Litigation Committee has not adopted a formal securities litigation policy (see recommendation above regarding adoption of a formal securities litigation policy)¹⁵⁵ nor has it delegated authority to staff to establish a securities litigation implementation protocol.¹⁵⁶

¹⁵³ We were informed that there is not a date for this document.

¹⁵⁴ We were informed orally that the Governor's Office of General Office requested that both SERS and PERS submit a document regarding their respective securities litigation processes.

¹⁵⁵ PSERS has a formal securities litigation policy.

¹⁵⁶ The Resolution does delegate authority to the Executive Director, with advice of SERS' Legal Office, to establish a list of qualified law firms to represent or advise SERS in connection with potential securities litigation.

Recommendations IE-2 and IE-3	SERS Response
<i>The Securities Litigation Committee should memorialize their acceptance of the “Proposed Steps in Securities Litigation Process for SERS” and Factors to Consider in Deciding Whether to Seek Lead Plaintiff Status in Securities Class Actions” by resolution.</i>	CONCUR: A securities litigation policy satisfying this recommendation was adopted by the Board at its meeting on May 31, 2006.
<i>The Securities Litigation Committee should establish the authority it retains to itself and the authority it delegates to SERS staff.</i>	CONCUR: A securities litigation policy addressing this recommendation was adopted by the Board at its meeting on May 31, 2006.

***The SERS Securities Litigation Procedural Document
Contains Many of the Fundamental Elements
of a Policy Implementation Protocol***

“Proposed Steps in Securities Litigation Process for SERS” and “Factors to Consider in Deciding Whether to Seek Lead Plaintiff Status in Securities Class Actions” (the “SERS Securities Litigation Procedural Documents”) establishes the procedures to be followed in identifying and evaluating potential securities class action. Both documents contain many of the substantive components of an implementation protocol. The Proposed Steps in Securities Litigation Process for SERS provides a good general outline of the process and makes it clear that the SERS’ Legal Office plays the primary role in the steps outlined for monitoring and evaluation. The role of the SERS Legal Office is subject to the Securities Litigation Committee, the Governor’s Office of General Counsel and the Office of the Attorney General, assisted by SERS internal sources (ARC and the Investment Staff) and SERS external resources (e.g., IRSS¹⁵⁷).

***The SERS Securities Litigation Procedural Documents Do Not
Address a Number of Key Elements in the Securities Litigation Process***

¹⁵⁷ Investor Responsibility Support Services (IRSS). IRSS is used by numerous public pension funds to assist them in monitoring securities class actions and filing and monitoring proof of claims.

A number of fundamental elements are missing from the SERS Securities Litigation Procedural Documents. For example, the SERS securities litigation steps do not address –

- The specific of the claims identification process;¹⁵⁸
- The process determining class membership; or
- Identification of the predetermined formula for calculation of initial damages estimates.¹⁵⁹ (Establishing a predetermined formula is important because there are several formulas¹⁶⁰ and combinations of such that may be used to produce a range of the pension fund's potential recovery. Using a predetermined formula promotes consistence and diminished the potential for undue influence from outside pressures);

The following is an example of the *typical method* (although not necessary the most accurate because it does not consider market-related loss during the period) *used to estimate losses for initial case evaluation purposes – the FIFO formula*:

¹⁵⁸ The IRSS contract provides for a number of IRSS Services. However, we found no SERS document which addressed the extent to which SERS utilizes the compliment of IRSS Services offered.

¹⁵⁹ The approach to damages estimation used for purposes of initial claims evaluation (i.e., whether it is cost effective to proceed) is very different from the methodologies that are used in litigation to obtain lead plaintiff status, enhance recovery or allocate a settlement. This is because the objectives are different. (NAPPA Securities Litigation Damages Calculation Taskforce Report intended as informational source for NAPPA members only – SERS is a NAPPA member.). We are aware that the IRSS contract with SERS set forth the process that will be used to calculate the loss estimate.

¹⁶⁰ **The FIFO formula** – first in, first out – is the formula that is typically used for the initial case valuation (however, the formula does not eliminate market-related losses from the value of the case). **The Recognized Damages formula** is another, more conservative sometimes controversial, formula that may also be used for initial case valuation. **The Constant Ribbon formula** is another formula that may be used, but because of its complex nature (it seeks to extricate market-related losses) it is typically used by experts and thus not typically used for initial evaluations.

- Calculate the average stock price for the 6 months prior to the public announcement of the action which precipitated the stock decline (the beginning of the “class period”);
- Compare this with the average price during, and for 90 days after, the class period. This difference represents the potential market loss due to the fraud; and
- Net the fund’s actual purchases and sales during the class period, and compare actual costs with the potential market loss. This represents the fund’s specific potential loss.

The phases of the case evaluation process and who has responsibility for the steps of each phase.¹⁶¹ (*See discussion of Phase I and II evaluations in the background section of this task area.*) We were informed that case evaluation is performed internally by SERS’ Legal Office. Many funds utilize external evaluation counsel. This can not be determined from the document.

- The criteria for determining the involvement of SERS, if any, if it decides not to seek lead plaintiff status (e.g. active monitoring of the litigation;
- The claims management and reconciliation process;
- The role of the custody bank in the process.¹⁶²

¹⁶¹The case evaluation process is the decision making framework used to determine whether the benefits of engaging in proactive litigation substantially outweigh the associated costs or otherwise merit additional consideration.

¹⁶²The document which sets forth the role of the custodian – Exhibit D – is part of the Treasurer’s contract with the custodian bank. It also sets forth the custodian bank’s class action responsibilities. Specifically the custodian bank is required to file a claim in any class action where it identifies a viable claim. A viable claim is defined as a claim with a reasonable likelihood of success which has been brought to the attention of the custodian bank by its own efforts or other specified parties (Treasury, a Fund, Investment Manager, Investment Advisor, broker, claims administrator, prior subcustodian, or other knowledgeable individual). We are aware that the custody bank (Mellon) provides a class action report that lists the cases and their status. However this is not required in Exhibit D.

Further, while SERS has set forth the “Factors to Consider in Deciding Whether to Seek Lead Plaintiff Status in Securities Class Actions” which describes the issues to take into account in coming to a decision whether or not to seek lead plaintiff status, as well as potential alternatives to becoming lead plaintiff, the document does not address how and by whom it will be utilized. The document does not address the circumstances that should be considered in determining whether to “opt-out” of the class and pursuing an individual claim.

***Detailed Documentation Removes Uncertainty Regarding
Who is Responsible for What, When, and How,
Mitigating Both Operational and Performance Risk***

The SERS Legal Office believes that the current documentation is adequate. We do not agree. The current document assume a level of knowledge regarding the interrelationship of the steps, the factors, and the key parties involved in the process that are not be gleaned on the face of the documents as they are currently drafted. For example, the five page flow chart provided to IFS is an excellent description of the class action process SERS utilizes to monitor, evaluate, and file claims. The flow chart is comparable to an implementation protocol and could be used for SERS for that process. It provides a more comprehensive, integrated, description of the specific steps in the securities litigation process, the roles and responsibilities of the key parties in the process, and at what phase and by whom the litigation decision making factors are considered (internal and external). Adoption of this type of document facilitates good governance and therefore be more consistent with best practices.

Recommendations IE-4	SERS Response
<i>We recommend that a document in narrative or flow chart form be adopted which identifies with particularity the steps and interrelationship of the key parties in the securities litigation process.</i>	CONCUR: A securities litigation policy addressing this recommendation was adopted by the Board at its meeting on May 31, 2006.

We were informed that the SERS Securities Litigation Committee “acknowledged and accepted the “Proposed Steps in Securities Litigation Process for SERS.” It appears that SERS believes that the process of “acknowledgement and acceptance” is analogous to formal adoption. We do not concur. See Recommendation IE-4 above.

The policy should also address certain fundamental roles and tasks including:

- The information the evaluation firm must provide, and
- If an evaluation firm is used, the timeframe for obtaining the information as well as to whom the information should be provided should be specified. If an evaluation firm is not going to be used, this should be stated.

SERS Has a Well-Defined Internal Claims Monitoring Process

The ARC procedures set forth an extensive step by step process for monitoring class action claims. The stated purpose of the procedure is to file securities litigation claims on a timely basis ensuring monetary recoveries entitled to by SERS. The document is very comprehensive, describing with specificity each stage of the claims monitoring process and the duties of each party involved in the process. Internally, ARC, legal, and SERS’ Office of Finance and Administration are the parties designated to implement the process. Externally, ISS,¹⁶³ Mellon,¹⁶⁴ PNC,¹⁶⁵ and are the designated parties. The current securities process utilized by

¹⁶³ **Institutional Shareholder Services, Inc. (ISS)** is the world's leading provider of proxy voting and corporate governance services with over 20 years of experience. ISS serves more than 1,600 institutional and corporate clients worldwide with its core business — analyzing proxies and issuing informed research and objective vote recommendations for more than 33,000 companies across 115 markets worldwide.

¹⁶⁴ Mellon is the custodian bank selected by the Treasurer and is part of **Mellon Financial Corporation** is one of the world's leading providers of financial services for corporations, institutions and affluent individuals around the globe.

¹⁶⁵ PNC Bank, part of PNC Financial Services Group.

SERS may be necessary because of the complexities caused by the custody bank change.¹⁶⁶ However, it appears to be fairly labor intensive and consumes significant staff time. Yet, SERS believe this is the more cost effective approach. Moreover although SERS has recently retained IRSS for claims identification, it has continued to also use ISS for claims identification. It is our understanding that SERS believes since IRSS is relatively new it is appropriate to have IRSS and ISS perform mirror function. Although much smaller than ISS, IRSS is utilized by a number of knowledgeable public pension funds. We have not done a cost analysis; however, we continue to question the need for this redundancy for purposes of claims identification.

Recommendations IE-5 and IE-6	SERS Response
<i>We recommend SERS reevaluate the current redundancy in its claims identification and filing process to determine whether it is still necessary.</i>	CONCUR: Staff will assess the current process and will adjust the process accordingly based on the assessment.
<i>We recommend that the custodian bank agreement be amended to describe more particularly the custodian bank's scope of duties in the claims management process including, but not limited to, for example notice and reporting requirements, the custodian bank's obligations to handle the filing of all proofs of claims, and related tracking, collection and reporting duties now as well as the period prior to their retention, the custodian standard of care and liability for failure to file a claim, records retention, and duties regarding deficient or rejected claims.</i>	WILL CONSIDER: Staff works with Treasury during custodial bank negotiations. The most recent contract includes provisions for the custodian bank to file all viable claims on SERS behalf, including those identified by SERS, its advisors, or other knowledgeable parties. The terms of the agreement also include provisions for filing claims in the event the custodial relationship is terminated.

¹⁶⁶ When an entity changes its custodian the securities litigation claims process can become complicated because a claim may encompass a class period when the prior bank was custodian. If the transaction data regarding the prior period can not be transferred to the new custodian bank, it may be necessary to harmonize the claims filing, tracking, collection and reporting process between the prior and the current custodians.

3. Comparison of SERS' Securities Litigation Policies and Processes to Other Public Pension Funds

For purposes of comparing SERS' securities litigation processes to other pension funds, rather than using the "peer group" developed for the overall report, we selected the public pension funds that are known to be active in securities class action litigation activities.

Table I-E-1 - Comparison of SERS Policies and Processes to Other Pension Funds						
Pension Fund	Adopted Formal Policy	Minimum Loss Threshold	Primary Responsibility for Identification, Monitoring, and First-Tier Evaluation	Primary Responsibility for 2 nd -Tier Case Evaluation	Management of Policy	Final Decision to Proceed
SERS ¹⁶⁷	X ¹⁶⁸	\$3M	IRSS	External Law Firm(s)	Securities Litigation Committee	Board, General Counsel and Attorney General
PSERS ¹⁶⁹	✓	\$25M ¹⁷⁰	IRSS	External Law Firm(s)	Corporate Governance Committee	Board and Attorney General
SWIB ¹⁷¹	✓	\$25M	Staff w/ IRSS Evaluation Counsel ¹⁷²	External case review counsel	Legal Dept.	Board
NYC ¹⁷³	✓	X	IRSS	External Law Firm(s)	City Law Dept. and Comptroller	Boards
CalPERS ¹⁷⁴	✓	\$2M ¹⁷⁵	Staff w/IRSS	External Law Firm(s)	Legal Dept.	Investment Committee

¹⁶⁷ Pennsylvania State Employees Retirement System

¹⁶⁸ Resolution 2003-49 established the Securities Litigation Committee and its duties and responsibilities and defines the minimum loss threshold.

¹⁶⁹ Pennsylvania Public School Employees' Retirement System

¹⁷⁰ Only nine cases over the threshold since 1999.

¹⁷¹ SWIB – State of Wisconsin Investment Board

¹⁷² "Unless adequate internal resources are available, claims identified for further evaluation (i.e., that exceed the minimum threshold) are generally sent to experienced securities/litigation outside counsel retained specifically to evaluate claims and advise SWIB on options for prudently managing claims recoveries." To prevent bias, evaluation counsel used by SWIB is typically not eligible to be considered for lead counsel.

¹⁷³ Five pension fund boards, collectively the New York City Retirement Systems (Employees, Teachers, Police, Fire, and Board of Ed.).

¹⁷⁴ California Public Employees Retirement System

¹⁷⁵ CalPERS has been considering raising its minimum threshold for several years, but has not done so.

Table I-E-1 - Comparison of SERS Policies and Processes to Other Pension Funds						
Pension Fund	Adopted Formal Policy	Minimum Loss Threshold	Primary Responsibility for Identification, Monitoring, and First-Tier Evaluation	Primary Responsibility for 2 nd -Tier Case Evaluation	Management of Policy	Final Decision to Proceed
CalSTRS ¹⁷⁶	✓	\$5M ¹⁷⁷	Staff	External Law Firm(s)	Legal Office and Subcommittee on Corporate Governance/Investment Committee.	Subcommittee on Corporate Governance/Investment Committee.
LACERA ¹⁷⁸	✓	\$2M	IRSS	External Law Firm(s)	Legal Office	Board of Investments
OPERS ¹⁷⁹	✓	\$10M	IRSS	External Law Firm(s)	Legal and Corporate Governance	Board ¹⁸⁰

Based on a comparison of SERS policies and processes to other public pension funds, we found no significant differences. A question was raised regarding whether SERS' minimum loss threshold was too low. You will note there does not appear to be a correlation between asset size and the minimum loss threshold. A number of the very large pension funds, CALPERS, CALSTRS, LACERA identified in Table I-E-1, also have very low minimum loss threshold. Notwithstanding, each have served as lead plaintiff. Hence, the pension fund level of involvement in actively monitoring and pursuing securities class action claim appears to be more a function of the philosophy of each individual Board rather than some correlation of particular factors.

Please see DAG's response at Exhibit G for comments on this section.

* * * *

¹⁷⁶ California State Teachers Retirement System

¹⁷⁷ Or in other cases where there is an exceptional opportunity to preserve or enhance the long-term value of a significant portfolio holding or to deter wrongful corporate conduct.

¹⁷⁸ Los Angeles County Employees Retirement Association

¹⁷⁹ Ohio Public Employees Retirement System

¹⁸⁰ OPERS participates on the Ohio Securities Litigation Advisory Panel which consists of members of the other Ohio retirement systems and representatives of the Ohio Attorney General's Office.

SERS CUSTOM PEER GROUP SURVEY RECIPIENTS

Public School Employees Retirement System of PA (PSERS)

State of Connecticut Trust Funds

Illinois TRS

Iowa PERS

LACERA

Mass PRIM

Minnesota State Board of Investment

Mississippi PERS

Missouri Public School

Missouri State Employees Retirement System (MOSERS)¹

Nevada Public Employees

Virginia Retirement System

Colorado PERA

Maryland State Retirement and Pension System

Washington State Investment Board (WSIB)

State of Wisconsin Investment Board (SWIB)

¹ Added at client's request.

SERS CUSTOM PEER GROUP SURVEY RESPONDENTS

Public School Employees Retirement System of PA (PSERS)

Illinois TRS

LACERA

Minnesota State Board of Investment

Mississippi PERS

Missouri Public School

Missouri State Employees Retirement System (MOSERS)¹

Maryland State Retirement and Pension System

Washington State Investment Board (WSIB)

State of Wisconsin Investment Board (SWIB)

¹ Added at client's request.

INDEPENDENT FIDUCIARY SERVICES SURVEY
FOR
THE PENNSYLVANIA PUBLIC SCHOOL EMPLOYEES RETIREMENT SYSTEM AND
THE PENNSYLVANIA STATE EMPLOYEES RETIREMENT SYSTEM

NAME OF PENSION FUND: _____

NAME OF PERSON RESPONDING TO SURVEY: _____ TITLE: _____

PHONE NO: _____ EMAIL: _____

MAIN CONTACT: _____ TITLE: _____

CONTACT PHONE NO: _____ CONTACT EMAIL: _____

Please indicate if there are any portions of this survey that you would like us to maintain as confidential: _____

A. ASSETS MANAGED

1. Please indicate asset values as of 6/30/2005

Funds/Programs	Asset Value (\$000's)	% of Assets Managed Internally	% of Assets Managed Externally
Defined Benefit			
Other (e.g., DC)			

2. **For Defined Benefit Program(s) managed-** Please identify each asset class and strategy utilized over the 12-months ended June 30, 2005, the amount invested, the percentage of the asset allocation represented, the percentage actively and passively managed, the percentage of internal¹ and external² management used and the number of external managers utilized.

¹ Except as otherwise noted, throughout this survey, assets are “internally managed” if your Board (or sole Trustee) retains ultimate decision-making authority over individual investments, or has delegated authority to the investment staff, even if advised by a third party.

² For purposes of this survey, assets are “externally managed” if such authority has been delegated to an outside entity, such as a registered investment advisor, bank, insurance company, general partner of a limited partnership or comparable delegate, selected by the Board and overseen by the Board, with assistance from staff and/or consultants.



Publicly Traded Assets – Asset Allocation					
Domestic publicly traded equities	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	Percentage Managed		No. of External Managers
			Internally	Externally	
Actively Managed					
Passively Managed					
International publicly traded equities/developed markets (EAFE)	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	Percentage Managed	Percentage Managed	No. of External Managers
			Internally	Externally	
Actively Managed					
Passively Managed					
International publicly traded equities/emerging markets	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	Percentage Managed	Percentage Managed	No. of External Managers
			Internally	Externally	
Actively Managed					
Passively Managed					
Domestic publicly traded fixed income	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	Percentage Managed	Percentage Managed	No. of External Managers
			Internally	Externally	
Actively Managed					
Passively Managed					
International publicly traded fixed income/developed markets	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	Percentage Managed	Percentage Managed	No. of External Managers
			Internally	Externally	
Actively Managed					
Passively Managed					
International publicly traded fixed income/emerging markets	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	Percentage Managed	Percentage Managed	No. of External Managers
			Internally	Externally	
Actively Managed					
Passively Managed					
Cash & equivalents	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	Percentage Managed	Percentage Managed	No. of External Managers
			Internally	Externally	



Private Assets – Asset Allocation			
Private equity (LBOs, Venture Capital, etc.)	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	No. of External Managers
Internally Managed			
Externally Managed			
Real estate	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	No. of External Managers
REITs			
Real estate equity (all types, including developmental, fully leased, and agricultural)			
• Internally Managed			
• Externally Managed			
Real estate loans	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	No. of External Managers
Loans secured by real estate			
• Internally Managed			
• Externally Managed			
Hedge Funds (Market neutral, long-short, convertible arbitrage, managed futures, global macro, etc.)	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	No. of External Managers
Internally Managed			
Externally Managed			
Other “alternative” assets (including timber, oil and gas, etc.) <i>Please specify type of asset</i>	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	No. of External Managers
Internally Managed			
Externally Managed			
Commodities/Inflation Protection <i>Please specify type of asset</i>	Amt. (\$ Billions)	Percentage of Total Fund Asset Allocation	No. of External Managers
Internally Managed			
Externally Managed			



3. Performance - for the defined benefit program(s) managed - Please provide:

- a. The total, annualized rate of return of the defined benefit plan for each of the last five years ending June 30, gross of fees.

Annualized Performance of DB Plan – Gross of Fees				
6/30/2005	6/30/2004	6/30/2003	6/30/2002	6/30/2001

We understand that some funds also calculate Net of Fees performance, if so, please provide:

Annualized Performance of DB Plan – Net of Fees				
6/30/2005	6/30/2004	6/30/2003	6/30/2002	6/30/2001

- b. The total, annualized rate of return for whatever policy index³ or benchmark applies to the plan.

Annualized Performance of Policy Index/Benchmark				
6/30/2005	6/30/2004	6/30/2003	6/30/2002	6/30/2001

Please specify policy index/benchmark used _____.

- c. The total annualized rate of return by asset class for the last five years.

Asset Class	Annualized Performance of DB Plan By Asset Class				
	6/30/2005	6/30/2004	6/30/2003	6/30/2002	6/30/2001
Domestic Equity					
International Equity					
Domestic Fixed Income					
International Fixed Income					
Real Estate					
Private Equity					
Cash & Equivalents: • STIF • Separate account					
Hedge Funds					
Commodities					
Other (define)					

³ By "policy index" we mean the hypothetical portfolio consisting of investment in the passive alternatives for each of your asset classes, in the weightings specified as your strategic targets in your investment policy statement, e.g., 60% Wilshire 5000/30% Lehman Aggregate/10% NCREIF.



B. USE OF CONSULTANTS

1. Please identify whether your organization utilizes the following types of external, private sector professionals:

	<u>Number</u>	<u>Fee Paid Last Fiscal Year</u>
Generalist investment consultants	_____	_____
Real estate consultants	_____	_____
Private equity consultants	_____	_____
Actuarial consultants	_____	_____
Other specialty consultants (Please specify subject area _____)	_____	_____

2. Are the Consultants required to acknowledge fiduciary status? ☐ Yes ☐ No

3. Are the Consultants required to disclose conflicts (check boxes below)?

Brokerage Affiliations	<input type="checkbox"/>
Brokerage Referral Arrangements	<input type="checkbox"/>
Soft Dollar Compensation from Brokers	<input type="checkbox"/>
Payments from Investment Managers for Products/Services	<input type="checkbox"/>
Other (Please Describe)_____	<input type="checkbox"/>

4. Please check functions performed by consultant:

Asset Allocation Analysis	<input type="checkbox"/>
Manager Search	<input type="checkbox"/>
Drafting Manager Guidelines	<input type="checkbox"/>
Drafting Investment Policy Statement	<input type="checkbox"/>
Monitoring Manager Compliance	<input type="checkbox"/>
Negotiating Manager Fees	<input type="checkbox"/>
Preparing Quarterly Performance Reports	<input type="checkbox"/>
Rebalancing	<input type="checkbox"/>
Monitoring Custody	<input type="checkbox"/>
Monitoring Securities Lending	<input type="checkbox"/>
Transaction Cost Analysis	<input type="checkbox"/>
Proxy Voting Services	<input type="checkbox"/>
Developing Private Equity Strategy	<input type="checkbox"/>
Selection of Private Equity Partnerships	<input type="checkbox"/>
Participation on Advisory Boards	<input type="checkbox"/>
Developing Real Estate Strategy	<input type="checkbox"/>
Selection of Real Estate Partnerships	<input type="checkbox"/>
Other	<input type="checkbox"/>



C. COSTS

Please provide the costs incurred by your organization over the most recently-completed fiscal year in dollars and in basis points, relative to the fair market value (at the end of that year) of the categories of assets and categories of cost set forth below.

1. Investment Activities Cost⁴

	In Dollars	In Basis Points (relative to year-end value of the assets)	Internally Managed Costs ⁵	Externally Managed Costs ⁶
Total investment cost for the most recently completed fiscal year				
<ul style="list-style-type: none"> • Custodial Fees <ul style="list-style-type: none"> ○ Base Fee ○ Transaction Fees ○ STIF Fee 				
<ul style="list-style-type: none"> • Investment Consultant Fees 				
<ul style="list-style-type: none"> • Investment Related Administrative Costs <ul style="list-style-type: none"> ○ Investment Compensation 				
<ul style="list-style-type: none"> • Investment Mgmt Fees 				
Please break out average Manager Fee by Category:				
<ul style="list-style-type: none"> • Active Large Cap US Equity 				
<ul style="list-style-type: none"> • Active Small Cap US Equity 				
<ul style="list-style-type: none"> • Passive US Equity 				
<ul style="list-style-type: none"> • Active Non-US Developed Equity 				
<ul style="list-style-type: none"> • Active Emerging Markets Equity 				
<ul style="list-style-type: none"> • Passive Intl Equity 				

⁴ Costs paid by use of directed brokerage (which may not appear explicitly on your budget) should be included at their hard dollar equivalents (e.g., if a provider charged \$100,000 and accepted payment through brokerage at a conversion ratio of \$2 in brokerage for every \$1 in hard dollar fees owed, your cost figures would include that \$100,000). If your organization uses a commission recapture program, please show the costs after considering the rebates received, i.e., please reflect net commissions paid, not gross.

⁵ Internally managed costs are directly related to the internal management of the organization's investment funds/programs. Such costs include: investment staff and support salaries and benefits, brokerage commissions, investment consulting, legal, administrative and other directly attributable asset management costs.

⁶ By externally managed costs we mean costs directly related to the external management of the assets of the funds/program. Such costs should include: investment management fees, investment consulting fees, performance measurement fees, search fees, custodial fees, securities lending costs, brokerage commissions, legal fees, etc.



• Active US Core Fixed Income				
• Passive US Fixed				
• High Yield Bonds				
• International Fixed				
• Real Estate Funds/LPs				
• Private Equity LPs				
• Hedge Funds				
• Other (please describe)				

2. Administrative Cost Breakdown by Category

	In Dollars	In Basis Points (relative to the year-end value of the assets)
Total Administrative Expenses (net of Investment Related Administrative Expenses shown above)⁷		
• Non-Investment Compensation		
• Other Administrative Expenses		
General Overhead and Maintenance (subset of above)		
• Rent		
• Building utilities and maintenance		
• Telephones		
• Computer systems		
• Fixed assets		
• Other		

3. Is your System responsible for the administration of a healthcare program? ☐ Yes ☐ No

If so, what is the total administrative cost of this program? _____

⁷ e.g., Personnel, professional and technical services, communications, transportation and travel, utilities, insurance, depreciation, etc.



4. Does your System own its building? ☐ Yes ☐ No

If yes, do you lease a portion of the building to outside tenants? ☐ Yes ☐ No

D. COMPENSATION AND STAFFING

1. Full Time Employees

- a. Please provide an organizational chart for your entire System.
- b. Please identify the total number of full time equivalent employees ("FTEs") your organization employed as of the last day of your most recent fiscal year in each of the following categories of personnel and in total.

	Total FTEs	Professional FTEs	Support FTEs
Total FTEs			
Office of the Executive⁸			
Total Investment Staff			
• Public Equity Investment Function			
• International Equity Investment Function			
• Private Equity Investment Function			
• Real Estate Investment Function			
• Fixed Income Investment Function			
• Cash and Equivalents Function			
• Other (Please specify below)			
Total Non-Investment Staff			
• Investment Transactions⁹			
• Investment Accounting			
• Systems and Office Services (IT)¹⁰			

⁸ The Office of the Executive would generally include: the Executive Director, Chief Investment Officer, Chief Operating Officer, Internal Auditor, Chief Financial Officer, and their respective administrative support staff.

⁹ Functions in the investment transactions area generally include: defined contribution transactions, daily valued funds, trade execution/settlement, and stock distributions.

¹⁰ Functions in the systems and office services area generally include: custodian system interface, Lan/PC support, telecommunications, public disclosure, records management, procurement, data systems management planning, technology resources management, user training and documents, etc.



	Total FTEs	Professional FTEs	Support FTEs
• Legal			
• Management Services ¹¹			
• Benefits Administration			
• Other (Please specify below)			

2. Please provide the total salary and additional compensation (if any) paid with respect to each of the following positions (or categories of employees) in the most recently completed fiscal year. We recognize that different funds may use different titles to describe the same or comparable positions; which is why we ask you to provide position descriptions if possible. For any position/title that your organization does not utilize, please enter a "0."

<u>Position Title</u>	ACTUAL BASE COMP	BASE RANGE	SUPPLEMENTAL COMPENSATION		
			BONUS	INCENTIVE	OTHER
<u>Executive Director</u>					
CHIEF OPERATING OFFICER					
CHIEF INVESTMENT OFFICER					
CHIEF FINANCIAL OFFICER					
<u>Senior Investment Officers/ Directors</u>					
• Public Equity					
• Private Equity					
• Fixed Income					
• Real Estate					
• Cash and equivalents					
• Other _____					
• Other _____					

¹¹ Functions in this area generally include: investment information and publications, public information, audit, ethics compliance, legislation and rulemaking, etc.



Investment Officers/Portfolio Managers -- Please specify the number of employees for each of the following positions and the low, median and high salary for each. As an alternative, you may also provide the raw data (as an attachment) for each position and we will perform the calculations. If the position is responsible for directly investing assets (as opposed to only monitoring outside investment managers) please check the shaded column entitled *Mng*.

POSITION TITLE	#	Mng	Base Compensation			Bonus		Incentive		Other	
			Low	Median	High	Avg.	High	Avg.	High	Avg.	High
IOS/PORTFOLIO MANAGERS											
Public Equity											
Private Equity											
Fixed Income											
Real Estate											
Cash and equivalents											
External Manager Oversight											
Other _____											
Portfolio Analysts											
Public Equity											
Private Equity											
Fixed Income											
Real Estate											
Cash and equivalents											
External Manager Oversight											
Other _____											

TRADE & SETTLEMENT	#	Mng	Base Compensation			Bonus		Incentive		Other	
			Low	Median	High	Avg.	High	Avg.	High	Avg.	High
Chief Trader											
Trader(s)											

- Please provide (if possible, as an attachment) the agency position descriptions applicable for each position identified above as well as the performance evaluation criteria used.
- How often does your System conduct performance evaluations? _____.
- If employees are eligible for incentive compensation, how long has the program been in place? _____. If possible, please describe the program.
- Are any non-investment employees eligible for incentive compensation? ☐ Yes ☐ No



If so, please list the positions and whether it is the same program as for investment employees.

e. Are salaries subject to state classification and pay schedules? ☐ Yes ☐ No

f. Is there an annual cost of living adjustment? ☐ YES ☐ NO

3. Fringe Benefits

a. Retirement –

If the percentage of contributions from the employer is the same for all positions, please respond below.

i. **Defined Benefit**

Employee contribution _____% (as a percentage of salary)

Employer contribution _____% (as a percentage of salary)

ii. **Defined Contribution**

Employee contribution _____% (maximum allowable percentage of salary)

Employer contribution _____%

iii. **457 Plan**

Employee contribution _____%

Employer contribution _____%

b. Health Care – Please provide amount budgeted (for fiscal year 2004) as employer contribution _____.

Health Care Benefit Breakdown - Please check all health care benefits that are provided.

☐ Medical ☐ Disability ☐ Dental ☐ Vision ☐ Life Insurance

☐ Other _____

c. Other fringe benefits provided

Benefit	Offered	Who is Eligible?
Transportation allowance	Yes/No	
Agency Car	Yes/No	
Day Care	Yes/No	
Tuition Assistance	Yes/No	
Adoption Assistance	Yes/No	
Other _____		

4. Educational Level and Professional Designations and Position Turnover

a. Please identify the highest educational level and any professional designations achieved (e.g., MBA, CFA) for the position incumbents as of June 30, 2005, and the tenure of the



incumbent. If the incumbent has been in the position for less than five years, please provide the tenure of the prior incumbent (i.e., number of years the prior incumbent was in that position).

POSITION	HIGHEST EDUCATIONAL LEVEL ATTAINED	PROFESSIONAL DESIGNATIONS/LICENSES HELD (e.g., CFA, JD, etc.,)	TENURE OF INCUMBENT	TENURE OF PRIOR INCUMBENT (if current is less than 5 years)
Executive Director				
CHIEF OPERATING OFFICER				
CHIEF INVESTMENT OFFICER				
CHIEF FINANCIAL OFFICER				
SENIOR INVESTMENT OFFICERS/ DIRECTORS				
• Public Equity				
• Private Equity				
• Fixed Income				
• Real Estate				
• Cash & Equivalents				
• Other _____				
INVESTMENT OFFICERS/ PORTFOLIO MANAGERS				
• Public Equity				
• Private Equity				
• Fixed Income				
• Real Estate				
• Cash and equivalents				
• External Mgr Oversight				
• Other _____				
PORTFOLIO ANALYSTS				
• Public Equity				
• Private Equity				
• Fixed Income				
• Real Estate				
• Cash and equivalents				
• External Mgr Oversight				
• Other _____				



b. Staff Turnover

Year	A. Total Non-Investment Staff	Departures	B. Total Investment Professional Staff	Departures	C. Total Investment Support Staff	Departures	Average Total Staff on Payroll
Through 6/30/2005							
2004							
2003							
2002							

E. COMPENSATION AUTHORITY

		Yes	No
1.	Is compensation subject solely to the discretion of your organization's Governing Board (if applicable)?		
	If No, then who has authority? _____		
2.	Is your organization subject to state civil service requirements regarding compensation?		
3.	Is compensation subject to legislative approval?		

F. PERSONNEL AUTHORITY

		Yes	No
1.	Is the authorized number of staff positions subject to legislative approval?		
2.	Is the authorized number of staff positions subject to the approval by another agency or a member of the executive branch?		
2.	Does your organization have independent personnel authority (e.g., hiring, termination, promotion, etc.)?		

G. PROCUREMENT AUTHORITY

	Yes	No
Does your organization have independent authority to select and contract with:		
• Investment management firms?		
• Investment consultants?		



	Yes	No
• Law firms?		
• Auditors?		
• IT services?		
• Actuary?		
• General overhead (office space, telephones, computers)?		

H. CUSTODY ISSUES

	Yes	No
Does state law designate the official custodian of the assets (e.g., State Treasurer)?		
Does your governing body have the authority to select and contract with the custodial bank?		
Does state law mandate use of an in-state institution as the custodial bank?		
Is your custodial bank an in-state institution?		

2. Do you use a domestic bank as sub-custodian? _____

3. Does the custodial bank (or subcustodian) provide any of the following services?

- | | |
|--|--------------------------|
| Performance measurement | <input type="checkbox"/> |
| Performance attribution | <input type="checkbox"/> |
| Guideline compliance monitoring | <input type="checkbox"/> |
| Collection of withheld foreign dividends | <input type="checkbox"/> |
| Risk analytics | <input type="checkbox"/> |
| Portfolio transition services | <input type="checkbox"/> |
| Securities lending | <input type="checkbox"/> |

4. If you do securities lending, what percentage of revenues is paid to the agent bank (i.e., the "split")? _____

I. BROKERAGE PRACTICES

1. Does your System use soft dollars? ☐ Yes ☐ No

If so, please describe their use, i.e., are they used to purchase software or other items?



2. Does your System direct any of its publicly-traded equity managers to use any specific broker-dealers? ☐ Yes ☐ No

If so, what percent of trades do you ask managers to direct? _____%

What percent of trades were actually directed in 2004? _____%

If so, does the directed brokerage include a commission recapture program? ☐ Yes ☐ No

If yes, does it direct brokerage in order to pay for or defray any costs that the System would otherwise pay by way of "hard" dollars? ☐ Yes ☐ No

3. Brokerage policy

Has your System adopted any overall written policy or procedure regarding any aspect of its brokerage and trading practices? ☐ Yes ☐ No

If yes, does the written document address:

- Selection of broker-dealers by your internal portfolio managers? ☐ Yes ☐ No
- Use of in-state broker dealers? ☐ Yes ☐ No
- Use of minority-owned broker-dealers? ☐ Yes ☐ No
- Use of soft dollars, directed brokerage or commission recapture? ☐ Yes ☐ No

4. Transactions costs

- Does your System quantitatively measure and evaluate its transactions costs?
☐ Yes ☐ No
- If yes, do you utilize a third party consultant for that purpose? ☐ Yes ☐ No

J. COMMUNICATION POLICIES

Please check any of the following data/information that your System provides to members/retirees:

Website Access	<input type="checkbox"/>
Newsletter	<input type="checkbox"/>
Summary Plan Description	<input type="checkbox"/>
Telephone Hotline	<input type="checkbox"/>
Annual Report	<input type="checkbox"/>
Annual Benefits Summary	<input type="checkbox"/>
Other (Please describe)	_____

K. INVESTMENT ACCOUNTING SYSTEM



1. Your investment accounting system is (Please check.)

An in-house/proprietary system ☐

Purchased/leased system ☐

System Name _____

2. Our custodian maintains our accounting records. ☐

3. Combination of in-house investment accounting and third-party ☐

4. Please describe how the accounting records are separated between in-house and third-party.

L. GOVERNANCE ISSUES

1. How many board members does your System have? _____

Sole Trustee ☐ Yes ☐ No

2. Does state law direct or encourage the hiring of providers of investment related services with offices in your state? ☐ Yes ☐ No

3. Does state law direct or encourage the investment of assets in companies doing business in your state? ☐ Yes ☐ No

4. Does state law direct or encourage the hiring of providers of investment related services owned by women or minorities? ☐ Yes ☐ No

5. Does state law establish limits on the amount or percentage of assets which may be invested in securities issued by particular companies? ☐ Yes ☐ No

6. Does state law identify particular asset classes eligible for investment and render other asset classes ineligible for investment? ☐ Yes ☐ No

7. Does state law establish limits on the amount or percentage of assets which may be invested in particular asset classes? ☐ Yes ☐ No

8. Does state law establish size or other qualifications for issuers of securities in which assets may be invested? ☐ Yes ☐ No

9. Does state law limit out-of-state travel by members of your governing body or staff for purposes of education? *Board:* ☐ Yes ☐ No *Staff:* ☐ Yes ☐ No



Exhibit D - SERS Peer Group – Board Composition

System	Number of Board Members	Elected by System Members	Ex-Officio Members	Legislature's Appointees	Other
Illinois TRS	11	6	1	0	–
Iowa PERS	7	0	1	0	–
L.A. County Employees Ret. Assn.	9/9 ¹	4	1	4	–
Mass. PRIM	9	4	2	0	State Treasurer appoints 1 Board member
Md. State Retirement and Pension System	13	5	3	0	–
Minn. SBOI	4	0	4	0	–
Miss. PERS	10	8	1	0	–
Missouri PSERS	7	4	0	0	–
Nevada PERS	7	0	0	0	–
SWIB	9	0	2	0	2 Retirement System members appointed by Retirement Boards
Virginia Retirement System	9	0	0	0	–
Wash. State Inv. Bd.	10	0	3	2	2 active retirement system members appointed by Superintendent of Public Instruction

¹ LACERA has two boards. The Retirement Board has 9 member and two alternates. The Investment Board has 9 members.

Sample of Key Parties Roles and Responsibilities

This is a sample. It is for illustrative purposes only. It is not intended to define the roles and responsibilities of the actual key parties involved in the SERS securities litigation process

Board Role and Authority:

- Review periodic [monthly] reports regarding securities litigation matters
- Periodically review and, as appropriate, modify this Policy
- Establish, periodically review and, as appropriate, modify Protocols for implementation of this Policy

Board [or Securities Litigation Committee] Role and Authority:

- Authorize commencement of separate litigation or filing of motion for lead plaintiff status
- Approve settlement of separate litigation or class action in which the pension fund is lead plaintiff
- Authorize opting out of a class settlement
- Determine whether to retain a securities class action monitoring firm and/or “Evaluation Counsel” to identify and evaluate potential claims and, if so, oversee the process for selecting such firm(s)
- Approve, modify or terminate agreements with service providers responsible for implementation of policy

Executive Director/Chief Investment Officer Role and Authority

- Monthly report to Board regarding securities litigation matters
- Authorize filing of objections and comments on settlements consistent with Board policy [this function could also be performed by a Securities Litigation Committee or the Board]
- Approve, circulate, and review responses to requests for proposals for service providers (e.g., custodian, class action monitoring firm and Evaluation Counsel) and make recommendations to Board regarding candidates

- Monitor performance of service providers and report deficiencies to the Board
- Select and purchase for the System subscriptions for services providing information regarding securities class action filings and settlements
- As appropriate, recommend to the Board modifications to the Policy and Implementation Protocols

Role and Authority of SERS' Legal Office

- Chief Counsel
- other SERS legal positions

Role and Authority of Governors Office of General Counsel

Role and Authority of OAG

Role and Authority of Service Providers (e.g. monitoring firms, evaluation counsel, litigation counsel, etc.)

Role and Authority of ARC

Role and Authority of Treasurer

- Custody Bank

In-house General Counsel Role and Authority

- Prepare draft requests for proposals for all providers of legal services, review responses and make recommendation to Executive Director regarding candidates
- Negotiate terms of agreements with all service providers
- Review, prior to submission to the Board, all recommendations from outside legal counsel, regarding whether to commence separate litigation or seek lead plaintiff designation, or to opt out of class settlements
- Review, prior to submission to the Board, all recommendations from outside legal counsel regarding proposed settlements of separate actions

brought by the pension fund or class actions in which the pension fund is lead plaintiff

- Review, prior to submission to the Executive Director, all recommendations from outside legal counsel regarding whether to file objections to or comments upon settlements
- Supervise outside counsel's conduct of litigation when Fund pursues separate litigation or acts as lead plaintiff

Custodian Role and Authority

- Maintain and communicate data necessary to identify Fund's securities holdings and transactions in order to determine if the pension fund is a class member, calculate amount of the pension fund's losses and prepare proofs of claim
- Collect and distribute to appropriate parties (i.e., monitoring firm, Evaluation Counsel, litigation counsel) all notices regarding the commencement, class certification and settlement of class action lawsuits in which the pension fund has an interest as an actual or potential class member
- Collect, and deposit into appropriate accounts for investment, proceeds of the pension fund's claims

Custodian/Class Action Monitoring Firm Role and Authority¹

- Establish and implement procedure to identify all securities class actions filed by others in which the pension fund is or may be a class member
- Collect and distribute all official notices of pendency of class actions in which the pension fund, according to this Policy, may consider applying for lead plaintiff status or pursuing separate litigation
- Calculate pension fund losses to determine if the pension fund's claim exceeds loss thresholds in this Policy
- Timely file proofs of claim on behalf of the pension fund in all class actions in which the pension fund may participate as class member

¹ Many custodial banks can and will provide these services as part of the custody process. Fund staff can also perform some of these functions. And there are outside service providers who can do some or all of these tasks. Some of those service providers are law firms who can also fill the role of "Evaluation Counsel".

- Provide monthly reports to Executive Director regarding status of all class actions in which the pension fund is a class member, including status of all proofs of claim

Evaluation Counsel Role and Authority

- Identify circumstances in which the pension fund may have incurred investment losses which give rise to potentially meritorious claims for the pension fund which are not yet the subject of litigation
- Evaluate claims over \$(e.g., \$1,000,000) threshold and recommend whether the pension fund should pursue separate litigation or lead plaintiff designation
- Evaluate settlements of actions in which the pension fund is not lead plaintiff where the pension fund losses exceed \$(e.g., \$500,000) and recommend whether the pension fund should object to, comment upon or opt out of settlement
- File objections to and comments upon settlements as authorized

Exhibit F

Summary of Recommendations

Set forth below is a summary of the recommendations from the preceding report and SERS' responses. They are listed in the order they appear in the report by task area for ease of reference.

Number	Recommendation	SERS Response
A-1	<i>The Board should support and implement legislation to give the Board the power to elect the Board's Chairman for a fixed term not to exceed two years, with the legislation making clear that the Board members' votes on the election of the Chairman are fiduciary acts subject to the same standard of prudence that applies to all their decisions regarding the management of the System. We are not proposing term limitations. Consequently, a member could serve successive two year fixed terms.</i>	CONSIDERED: The present board structure provides for continuity in executing long term strategic business, investment, and information technology plans and has served the Fund well. The structure's design serves to mitigate distractions or divisions at the board level that might otherwise arise due to a chairmanship election. The current structure has served the Fund and its membership well as born out by top decile long term returns, a well diversified plan, employer contribution costs that have been significantly below normal cost, and a funded ratio that is the envy of many peers throughout the country.
A-2	<i>The Board should support and implement legislation establishing a process for nominations by the SERS membership (or organizations certified to represent the membership) for some number of the Board seats appointed by the Governor.</i>	CONSIDERED: The current statute requires that at least five board members be active members of the system, and at least two shall have ten or more years of credited state service. In addition, the Executive Director of the AFSCME Council 13 representing the largest union membership and over 40,000 current employees, is on the Board. Increasing the size of the board would not appear to be value additive.
A-3	<i>The Board should support legislation requiring that at least one of the</i>	CONSIDERED: The SERS' Board through sound personnel hiring

Number	Recommendation	SERS Response
	<i>Governor's appointees to the Board have investment expertise. And in the absence of such legislation, the Board could recommend to the Governor that he or she fill one or more vacancies on the Board as they arise with individuals with investment expertise.</i>	practices has established an Investment Office staffed by well qualified investment professionals. In addition, the Board through sound due diligence has hired experienced well qualified investment consultants and investment managers. This core group of investment professionals provides the Board with the expert investment advice necessary to manage SERS.
A-4	<i>The Board should develop and adopt a formal Statement of Governance Principles.</i>	CONCUR: Staff will develop a formal Statement of Governance Principles for Board consideration.
A-5	<i>The Board should consider delegating to qualified staff authority to make certain investment decisions related to private equity, real estate and alternative investments, subject to guidelines established by the Board, with appropriate reporting requirements to the full Board or an appropriate Committee.</i>	CONSIDERED: The board believes the current process has served the System well. The process provides an approach whereby staff and consultant research the most highly skilled investment advisors and innovative products and present them to the Board for consideration and deliberation. Additionally, the current approach also incorporates using the Board approved discretionary reserve to fund top tier managers. The discretionary reserve acts to fund those opportunities in an accelerated manner and mitigates the procedure of Board presentations and deliberations prior to funding.
A-6	<i>The Board should establish committees in the areas of investments, budget and technology to meet and review staff and consultant recommendations in these areas and report regularly to the Board.</i>	CONSIDERED: The staff annually provides and obtains Board comments on drafts of a Strategic Business Plan and an Investment Plan. The Board then adopts the final versions of these plans. These plans include the technology and investment initiatives the System will be addressing during the year. Throughout the year the Board is

Number	Recommendation	SERS Response
		provided status reports relating to the progress of the Plan. SERS believes this approach provides a more efficient and effective approach to managing the operation than establishing various committees to address these same initiatives.
A-7	<i>The Board should, by formal resolution, adopt charters for each of its committees to detail the scope and limits of their authority and the subjects within their jurisdiction, and their basic rules of procedure.</i>	WILL CONSIDER: Where appropriate, staff will draft charters for Board approved committees.
A-8	<i>Staff should be required to acknowledge by signature the receipt of, and agreement to, all IT policies and procedures.</i>	CONCUR: Staff will develop the appropriate document for signature by all staff members.
A-9	<i>SERS should establish the internal audit activity as a functional unit that is independent of the organizational activities it is supposed to audit. (Please see Recommendations IA-1- and IA-11 on the middle office, below.)</i>	WILL CONSIDER: SERS is reviewing the alignment of responsibilities within certain bureau functions.
A-10	<i>SERS should establish a Middle Office in order to enhance internal controls, specifically separation of potentially incompatible functions.</i>	CONCUR: SERS is in the process of developing and staffing an office such as the one recommended.
A-11	<i>Certain investment related accounting functions now performed by Audits, Reporting and Compliance should be modified as necessary and performed in the Middle Office as described in the accompanying Table I-A-2.</i>	WILL CONSIDER: SERS is reviewing the alignment of responsibilities within certain bureau functions.
B-1	<i>The Fund's methods for monitoring managers and investments are sound, but should be enhanced to reflect the sophistication of the Fund's investment program.</i>	CONCUR: SERS is researching and discussing best practices for monitoring new and innovative investment strategies with consultants and investment advisors and is working toward developing an effective approach toward risk reporting and measurement.

Number	Recommendation	SERS Response
B-2	<i>The Board should reconsider whether it would benefit from receiving more detail on the risks incurred by the Fund's investment program. If so, it should clarify for staff and the consultant the amount of detail on portfolio risks it requires.</i>	CONCUR: SERS and consultant have expanded disclosure of portfolio level metrics to the Board.
B-3	<i>The Fund should enhance its monitoring procedures to meet the specific challenges created by use of sophisticated "alpha transport", "long-short" or derivative strategies. The Board should instruct staff and the general consultant to develop additional analysis that can evaluate the risks and returns of these strategies.</i>	CONCUR: SERS is researching and discussing best practices for monitoring new and innovative investment strategies with consultants and investment advisors and is working toward developing an effective approach toward risk reporting and measurement.
B-4	<i>Review the investment guidelines for consistency and, in order to enhance the usefulness of the guidelines, consider including additional requirements (even if they are covered generally in the IPS), where appropriate to the asset class, such as:</i> <ul style="list-style-type: none"> <i>• proxy voting,</i> <i>• specific communication and reporting requirements, and</i> <i>• required action in case of a breach of guidelines.</i> 	CONCUR: As a matter of practice, staff review guidelines formally for each manager at least annually.
B-5	<i>The Board should continue to maintain direct communication with both staff and the specialty consultants so that the Board can insure that the close working relationship between staff and the consultants does not dampen any reasonable difference of opinion between about strategy, managers or performance.</i>	CONCUR: The consultant is present at each Board meeting to present its views and to address any questions and concerns of the Board as they arise.
C-1	<i>The Board should seek, and subsequently implement, legal authority to hire a staff attorney who would be appointed by and serve at the pleasure of the Board, with administrative reporting responsibility to the Executive Director. That legal</i>	CONSIDERED: There are advantages to having SERS' counsel be appointed by General Counsel and subject to the supervision of General Counsel. Such counsel owe a duty of loyalty and utmost care to SERS even though

Number	Recommendation	SERS Response
	<i>authority could take the form of appropriate legislation amending either or both of the Retirement Code and the Commonwealth Attorneys Act, or a binding, permanent directive from the General Counsel authorizing such an attorney's appointment. The Board should establish in writing the scope and limits of that SERS attorney's authority, as well as the relationship between the SERS attorney and the Commonwealth General Counsel.</i>	appointed by General Counsel. The Rules of Professional Conduct, which are applicable to both such counsel and General Counsel, should be sufficient to deal with any conflict situation. Indeed, even if SERS had authority to appoint its own counsel, it would often be relying on the integrity of that counsel to note instances of conflict and then on that attorney's compliance with the Rules of Professional Conduct. Finally, it is questionable whether one General Counsel could enter into an agreement binding on future General Counsels as to representation of SERS.
C-2	<i>So long as a Chief Counsel appointed by and serving at the pleasure of the Commonwealth's General Counsel remains the SERS attorney of record, the Board and the General Counsel should negotiate a formal, written Memorandum of Understanding setting forth the procedures to be followed (i) to identify situations in which, due to a conflict of interest or a need for specialized expertise, SERS and/or its Board may engage its own legal counsel, and (ii) to select and compensate such separate counsel.</i>	CONSIDERED: A memorandum of understanding is not a binding document. Also, it is not possible to contemplate in a meaningful way situations when special counsel may be needed. It should be sufficient to rely on compliance with the Rules of Professional Conduct.
C-3	<i>The Board should support the adoption of legislation amending the Commonwealth Attorneys Act to exempt SERS from the requirement to obtain approval of all contracts from the Attorney General and the General Counsel or, at the very least, to require approval from only one of them. Pending the enactment of such legislation, the SERS Chief Counsel should develop form contracts preapproved by the General</i>	CONSIDERED: As has been noted, the review by the Attorney General is not for business terms, but rather to assure compliance with certain important mandates such as non-waiver of sovereign immunity. The Attorney General is aware of the time sensitive nature of approvals of SERS' investment agreements and has responded in a timely manner. SERS' Legal Office has sought, and

Number	Recommendation	SERS Response
	<i>Counsel and the Attorney General to obviate the need for review of individual contracts consistent with the pre-approved form, leaving SERS leeway to negotiate and finalize the business terms of its contracts with approval from the SERS Chief Counsel.</i>	continues to seek, ways to standardize agreements in a way that might obviate the need for the General Counsel's and Attorney General's reviews.
C-4	<i>The Board should amend the Bylaws to add a provision clearly stating that designees of Board members are subject to the same standard of care as the Board members designating them.</i>	WILL CONSIDER: Although SERS believes that designees of Board members are subject to the same standard of care as the Board members, SERS will consider adding the suggested provision to its bylaws when they are next amended.
C-5	<i>The Board should support legislation to grant the Board autonomy in establishing its administrative budget to be paid from SERS' assets, provided that such legislation makes it clear that the Board's decisions regarding expenses to be paid from the assets are subject to a rigorous standard of fiduciary responsibility, including a duty of prudence and a duty to act for the exclusive benefit of SERS' members.</i>	CONCUR: The Board will evaluate options available that would enhance the autonomy in decisions relative to budget, procurement and compensations.
C-6	<i>The Board should support legislation to grant the Board authority to select and contract with the financial institution that will provide master custody services to SERS. Such legislation could require that the Board select the custodian from a list of institutions approved by the State Treasurer. Pending the enactment of such legislation, Board and the State Treasurer should collaborate in establishing a mechanism whereby the SERS Board and staff can provide to the State Treasurer meaningful input into significant issues related to the master custody relationship including:</i>	WILL CONSIDER: As noted, staff currently provides input and suggestions into the existing process and was involved in recent contract negotiations. The Treasurer has historically been sensitive and responsive to the needs of the Fund. As noted in the IFS report on page 113 "while it is optimal from a governance perspective for the Fund to have control over the selection of its custodian, the custodial arrangement in Pennsylvania is uncommon and advantageous." We concur. This structure allows the state to use significant negotiating

Number	Recommendation	SERS Response
	<ul style="list-style-type: none"> the review of the performance of the custodian, possible enhancements to the services provided by the custodian, any decision to replace the custodian, development of the scope of services to be provided by any new custodian and the selection of a new custodian 	leverage for the delivery of custodial services at what IFS notes as “a very attractive fee arrangement.”
C-7	<i>The Board should support legislation to grant the Board autonomy in procurement and personnel policies, provided that such legislation makes it clear that the Board’s decisions regarding expenses to be paid from the assets are subject to a rigorous standard of fiduciary responsibility, including a duty of prudence and a duty to act for the exclusive benefit of the SERS members.</i>	WILL CONSIDER: The Board will consider pursuing limited, judicious autonomy where it can be proven to improve the System’s governance.
C-8	<i>The Board should review on a comparative basis the Governor’s Code of Conduct and the Ethics Act and adopt rules incorporating the most stringent aspects of them to assure that all Board members are covered by the same requirements with respect to both conduct and disclosure. The rules should explicitly require that all designees comply with their requirements for so long as they are designees.</i>	WILL CONSIDER: To provide background for the Board, staff will obtain information from other retirement systems.
C-9	<i>The Board should adopt and implement a Board Member Travel Policy.</i>	WILL CONSIDER: The staff will prepare a policy statement for Board consideration.
C-10	<i>The Board should adopt “pay to play” rules to require by contract, and in materials submitted with requests for proposals for services, that service providers and prospective service providers not make political</i>	WILL CONSIDER: To provide background for the Board, staff will obtain information from other retirement systems. Staff will also attempt to obtain information regarding the proposed SEC

Number	Recommendation	SERS Response
	<i>contributions to any person who is a member of the Board, an official who appoints members of the Board, or to such a person's political committee.</i>	regulation cited by IFS that was not adopted and the reason for not adopting it.
C-11	<i>The Board should adopt a recusal policy identifying circumstances such as receipt of political contributions, outside financial interests, family relationships, etc. which would require a Board member or designee to recuse himself or herself from a particular discussion or decision.</i>	WILL CONSIDER: The Board has been following an informal recusal policy that complies with, and in some respects goes beyond, the conflict provisions of the Ethics Act. Staff will document and provide a formal policy for Board consideration.
D-1	<i>Given the growing importance of managing any potential conflicts, the Fund should seek to amend its contract with Rocaton to include annual disclosure as a contractual requirement.</i>	CONCUR: Rocaton currently includes all the suggested disclosures in its quarterly reporting. Nevertheless, staff will seek to amend the contract as recommended.
E-1	<i>We recommend that SERS adopt a formal securities litigation policy. The policy should (a) acknowledge that securities class action claims are plan assets (b) reference the trustees' fiduciary duty to take reasonable, cost-effective, steps to identify, analyze, pursue, and collect securities class action claims, (c) identify the objectives of the board of trustees in pursuing securities litigation, (d) set forth the evaluation and monitoring process that will be used, (e) describe decision making framework and criteria for determining the nature and level of the pension fund's efforts to recover losses, and (f) define the roles and authority of the key parties in the process (see Exhibit B – Sample of Key Parties Roles and Responsibilities).</i>	CONCUR: A securities litigation policy incorporating IFS's recommendations was adopted by the Board at its meeting on May 31, 2006.
E-2	<i>The Securities Litigation Committee should memorialize their acceptance of the "Proposed Steps in Securities Litigation Process for SERS" and Factors to Consider in Deciding Whether to Seek</i>	CONCUR: A securities litigation policy satisfying this recommendation was adopted by the Board at its meeting on May 31, 2006.

Number	Recommendation	SERS Response
	<i>Lead Plaintiff Status in Securities Class Actions” by resolution.</i>	
E-3	<i>The Securities Litigation Committee should establish the authority it retains to itself and the authority it delegates to SERS staff.</i>	CONCUR: A securities litigation policy addressing this recommendation was adopted by the Board at its meeting on May 31, 2006.
E-4	<i>We recommend that a document in narrative or flow chart form be adopted which identifies with particularity the steps and interrelationship of the key parties in the securities litigation process.</i>	CONCUR: A securities litigation policy addressing this recommendation was adopted by the Board at its meeting on May 31, 2006.
E-5	<i>We recommend SERS reevaluate the current redundancy in its claims identification and filing process to determine whether it is still necessary.</i>	CONCUR: Staff will assess the current process and will adjust the process accordingly based on the assessment.
E-6	<i>We recommend that the custodian bank agreement be amended to describe with more particularly the custodian bank’s scope of duties in the claims management process including, but not limited to, for example notice and reporting requirements, the custodian bank’s obligations to handle the filing of all proofs of claims, and related tracking, collection and reporting duties now as well as the period prior to their retention, the custodian standard of care and liability for failure to file a claim, records retention, and duties regarding deficient or rejected claims.</i>	WILL CONSIDER: Staff works with Treasury during custodial bank negotiations. The most recent contract includes provisions for the custodian bank to file all viable claims on SERS behalf, including those identified by SERS, its advisors, or other knowledgeable parties. The terms of the agreement also include provisions for filing claims in the event the custodial relationship is terminated.



COMMONWEALTH OF PENNSYLVANIA
OFFICE OF THE AUDITOR GENERAL
HARRISBURG, PA 17120-0018

JACK WAGNER
AUDITOR GENERAL

August 25, 2006

Samuel W. Halpern, President
INDEPENDENT FIDUCIARY SERVICES, INC.
805 15th Street, NW, Suite 1120
Washington, DC 20005

Dear Mr. Halpern:

The Department of the Auditor General ("Department") has reviewed the draft of SERS Report I, dated July 10, 2006, which provides the results of a portion of the "investment fiduciary review" of the Pennsylvania State Employees' Retirement System ("SERS" or "System") that was conducted by Independent Fiduciary Services, Inc. ("IFS"). The report discusses the objectives performed by IFS in support of the objectives performed by this Department in our special performance audit of the investment operations of SERS. Our response to SERS Report II, which discusses objectives performed only by IFS, is provided in a separate letter.

In general, SERS Report I appears to provide the management of SERS with many reasonable recommendations as to how it can improve SERS' investment operations and, thereby, accomplish the organization's mission more effectively. There are, however, several issues on which we strongly disagree with IFS' narrative and recommendations.

As required by the Agreement, the comments of this Department and the System must be addressed to the satisfaction of the party making the comment or else the comment must be included verbatim in the report. Despite the opportunity to comment, we continue to maintain that there should also be a disclaimer stating that this Department is not responsible for any errors that may be in the IFS reports.

Section II - Background, Review Methodology, and Limitations on the Report

- On pages 12-13 of the report, IFS acknowledges the use of recognized “best practices” as baselines for evaluating SERS’ performance. More specifically, on page 13, IFS cites to the Uniform Management of Public Employee Retirement Systems Act (“UMPERSA”) as a “best practice” used in its analyses. The Department takes exception to IFS citing to UMPERSA, which has only been adopted by two states in its entirety since its promulgation by the National Conference of Commissioners of Uniform State Laws in 1997, as a rationale for extracting SERS and the State Employees’ Retirement Board (“Board”) from the executive branch of state government or granting it additional autonomy exceeding that of other state agencies (including in some cases, that of independent state agencies) with regard to budgetary, personnel, and procurement authority. The comment to Section 5 (pertaining to Powers of Trustee) of UMPERSA, states, in pertinent part: “This section is intended to ensure that retirement system trustees have *a level of independence sufficient to permit them to perform their duties and to do so effectively and efficiently.*” (Emphasis added.) What IFS fails to acknowledge is that, in the absence of examples of ways in which the System and its Board – which is an “independent administrative board” under the SERS Retirement Code – are hampered by the existing degree of autonomy, it must be concluded that the System’s current level of independence is already “sufficient” to allow it to perform its duties in an effective and efficient manner as called for by UMPERSA. IFS has provided absolutely no evidence to the contrary.

Furthermore, we do not agree, as IFS suggests, that the fiduciary duties imposed on trustees of public pension funds under law would provide sufficient assurance that, if SERS’ Board members were granted the independence recommended in the IFS report to oversee all operations of the System, the interests of the legislature, taxpayers, members, and retirees would be adequately protected.

SERS’ Board and the board of its counterpart, the Public School Employees’ Retirement System (“PSERS”), oversee the investment and management of more than \$70 billion in combined assets. It is unlikely that the Commonwealth will grant complete independent responsibility for the management of these assets to the respective boards. A recommendation of this type, as IFS includes in its report, would require a complete restructuring of each system’s board and the laws governing each system, which would be at considerable expense to taxpayers with no corresponding tangible benefits in return.

Additionally, the fact that SERS' legal liability resides ultimately with the Commonwealth may explain why the General Assembly may be skeptical about adopting UMPERSA. If individual Board members believe there was a high probability that they might be sued for breach of fiduciary duty, they would be unwilling to serve unless they were fully indemnified by the Commonwealth or provided adequate insurance. Because the Commonwealth would ultimately bear the costs of indemnification, the state essentially bears the liability associated with any failure in Board member fiduciary conduct.

Therefore, we believe that fiduciary duty and its associated legal liability alone are insufficient to provide the General Assembly with the assurances needed to grant Board members independent authority over the administration of SERS' assets. It further explains why the Governor's Office of General Counsel ("OGC") opposed the adoption of UMPERSA in 1997 and why, as of the date of this letter, only two states have enacted UMPERSA in its entirety into law. Instead, state governments are ensuring that they are represented to some extent on the fiduciary boards through representatives of the state treasury and the executive and legislative branches and/or retain some degree of authority, such as over budget appropriations.

- Page 18 – IFS states under "Report Caveats" (second bullet), its assumption that survey information provided by the "custom peer funds" used within the report "is accurate, and could be relied upon." This Department conducted a similar survey with the assistance of the National Association of State Retirement Administrators, which granted us permission to temporarily access its online contact list of 80 public pension systems across the country. We received 28 survey responses, including ten from the same peer funds used by IFS.

For six of those ten funds, the results of our survey appear to differ from IFS' results. Those six funds indicated that they have a lesser degree of decision-making autonomy in terms of budgetary, personnel, and/or procurement authority than evidenced by the IFS survey results. Chapter 2 of our report discusses the results of our survey in greater depth.

Samuel W. Halpern, President
INDEPENDENT FIDUCIARY SERVICES, INC
August 25, 2006
Page Four

Section III – Task I-A: Organizational Structure and Resources

The following comments by IFS lack clarity and/or enough detail to support the conclusion presented by IFS:

- Page 37 – IFS recommends that the SERS Board “consider delegating to qualified staff the authority to make certain investment decisions related to private equity, real estate and alternative investments, subject to guidelines established by the Board, with appropriate reporting requirements to the full Board or an appropriate Committee.” Although the SERS Retirement Code does not contain a specific prohibition on investment decision delegation to staff, we question whether such delegation will enable the SERS Board members to exercise sufficient investment decision oversight, thus potentially compromising their ability to meet their fiduciary obligations.¹ In particular, Section 5931(e) of the SERS Retirement Code imposes upon SERS Board members “the obligation to invest and manage the fund for the exclusive benefit of the members of the system....”² We are pleased that, in its response to this IFS recommendation, SERS acknowledges that “the current process has served the System well. The process provides an approach whereby staff and consultant research the most highly skilled investment advisors and innovative products and present them to the Board for consideration and deliberation.”
- Page 39 – IFS notes that some SERS Board members feel that they are “overly dependent on the staff and consultants.” However, delegating

¹ In footnote 72 on page 37, IFS states, “IFS is not aware of any impediment in the Retirement Code or elsewhere in Pennsylvania law which would prohibit such a delegation and neither SERS staff nor the Auditor General’s office has brought such a provision to IFS’s attention after inquiry.” This Department submits that any reference in this footnote to our Department should be deleted given the fact that we have previously pointed out to IFS that the delegation of investment decisions related to private equity, real estate, and alternative investments, even with Board reporting requirements, may hamper the SERS Board members’ ability to properly carry out their fiduciary duties. Furthermore, the absence of an explicit prohibition in a statute, such as the SERS Retirement Code, against a proposed practice does not necessarily make the practice prudent, one that is authorized, or, for that matter, one that was intended by the legislature. Pursuant to Section 1921(a) of the Statutory Construction Act, 1 Pa.C.S. § 1921(a), “The object of all interpretation and construction of statutes is to ascertain and effectuate the intention of the General Assembly. Every statute shall be construed, if possible, to give effect to all its provisions.” Delegating these types of investment decisions to staff may undermine the Board members’ ability to ensure that all related investments are for the exclusive benefit of the SERS plan members and, therefore, may not give proper effect to this provision of the SERS Retirement Code.

² 71 Pa.C.S. § 5931(e).

investment decisions related to private equity, real estate, and alternative investments, as recommended by IFS on page 37 and discussed in the preceding bullet, will further increase dependence on staff input and decision-making to the possible detriment of System members.

- Page 41 – Although IFS has attempted to clarify, as we had previously requested, its discussion of “all-in-one” investment accounting systems and its statement that no such system exists at SERS, IFS continues to be unclear about whether it views SERS’ lack of an “all-in-one” investment accounting system” as a positive or negative factor.

Section III – Task Area I-B: Due Diligence Procedures

We agree that SERS’ investment manager due diligence and monitoring procedures are well-documented and applied in a manner consistent with written policies. In our audit, we reviewed the procedures used to reimburse investment managers for the services they provided and found that SERS did a thorough job of reviewing and approving investment manager service fees. The results of our review of investment manager due diligence and monitoring are discussed in Chapter 4 of our report.

In this section of SERS Report I, we noted several instances where IFS uses criteria or rules but does not provide the source(s) of or citation(s) for those criteria or rules. For example, on pages 53-54, IFS states that “several key components are required” for thorough monitoring of investment managers, and provides four such key criteria or components without acknowledging any source(s) for these criteria. Similarly, on page 61, IFS provides criteria/guidelines for equity and fixed income in six bullets without providing any source(s) for such criteria/guidelines. In order to allow SERS, this Department, and other readers or users of the report to evaluate its recommendations fairly, IFS should provide the actual source of all criteria used in the report or acknowledge that the criterion is merely a best practice in the sole opinion of IFS.

Section III – Task Area I-C: Legal Matters

IFS does not provide sufficient documentation to support several of the recommendations contained within this section of SERS Report I. In addition, the report fails to address the benefits that SERS receives from Commonwealth agencies such as the Governor’s Office of Administration, the Governor’s Office of the Budget, and OGC.

In particular, we note the following with regard to IFS' recommendations:

- Page 74 - IFS recommends that the SERS Board should seek, and subsequently implement, legal authority to hire a staff attorney who would be appointed by and serve at the pleasure of the SERS Board, with administrative reporting responsibility to the Executive Director. IFS further recommends that SERS seek a memorandum of understanding ("MOU") with the General Counsel providing for such authority and setting forth procedures for handling conflicts of interest and compensation until such time as legislation is enacted. IFS' recommendation with regard to the MOU seems to suggest that the MOU would permit SERS to engage its own legal counsel on a case-by-case basis where there is an identified conflict of interest or a need for specialized expertise.

However, IFS fails to provide any specific examples of instances in which SERS' Chief Counsel has had a conflict of interest in serving SERS and the Board. In fact, IFS states on page 75 of this section, "None of the Board, the Executive Director or the investment staff have expressed concerns with the quality or timeliness of the Chief Counsel's *support* for the investment functions." (Emphasis added.) This does not appear to provide appropriate justification for the SERS Board to go through the time and expense of pursuing a change to state law. In addition, it is not clear why an MOU is necessary because OGC already provides authorization for SERS to hire its own separate counsel on a case-by-case basis, which the System has exercised on occasion. In its response to this IFS recommendation, SERS lends further support to our conclusion when it states, "There are advantages to having SERS' counsel be appointed by General Counsel and subject to the supervision of General Counsel. Such counsel owe a duty of loyalty and utmost care to SERS even though appointed by General Counsel. The Rules of Professional Conduct, which are applicable to both such counsel and General Counsel, should be sufficient to deal with any conflict situation."

- Page 76 - IFS recommends that the SERS Board support the adoption of legislation amending the Commonwealth Attorneys Act to exempt SERS from the requirement that SERS and other state agencies must obtain approval of their contracts from the Office of Attorney General and OGC. This stems from IFS' conclusion that "identifiable value added from General Counsel and Attorney General involvement in SERS contracts has not been identified." IFS provides no conclusive, substantive evidence (despite the fact that we had previously requested the inclusion of such evidence) as to why IFS reached

this conclusion. In fact, on page 75, IFS indicates that both the General Counsel and the Attorney General have been responsive to SERS' Chief

Counsel's request to complete their reviews within tight time frames. In addition, we question why SERS should be exempted from a safeguard designed to ensure proper oversight of the contracting process. SERS' response to this IFS recommendation helps to further bolster the need for continued review of SERS' contracts by the Office of Attorney General: "As has been noted, the review by the Attorney General is not for business terms, but rather to assure compliance with certain important mandates such as non-waiver of sovereign immunity."

- Page 80 - IFS recommends that the SERS Board amend its bylaws to add a provision clearly stating that designees of SERS Board members are subject to the same standard of care as the SERS Board members who designate them. Although we are in agreement with SERS that it is apparent that the SERS Retirement Code subjects designees to the same standard as their principals,³ we believe that amending the bylaws to raise the awareness of all designees about their fiduciary obligations is a reasonable recommendation.
- In this same section (page 78), IFS concludes that the SERS Retirement Code articulates an appropriate standard of "fiduciary responsibility." However, we note that the standard is not consistent with the standard contained in the Uniform Prudent Investor Act ("UPIA"), which has been adopted by the Pennsylvania General Assembly through Act 28 of 1999 for all estates and trusts that fall under the jurisdiction of the orphan's court⁴ and contains a positive obligation to diversify investments.⁵ The SERS Retirement Code contains no reference to the requirement to diversify investments and also lacks other provisions contained in the UPIA, including, for example, important provisions dealing with portfolio management.⁶

³ See 71 Pa.C.S. § 5901(a); 71 Pa.C.S. § 5931(e).

⁴ See 20 Pa.C.S. § 7201 *et seq.*

⁵ See 20 Pa.C.S. § 7204(a).

⁶ See 20 Pa.C.S. § 7203(a). We also note that UMPERSA, which IFS heavily relies upon as a "best practice" in the industry, follows the UPIA with respect to the prudence standard. However, in stark contrast to the UPIA, which has been adopted in its entirety by the vast majority of states since its promulgation in 1994, UMPERSA has been adopted by only two states in its entirety since its promulgation in 1997.

Chapter 2 of our report includes a thorough discussion of this issue and recommends that the SERS Board pursue changes to the SERS Retirement Code to ensure that the prudence standard applicable to the SERS Board encompasses all of the key elements of Pennsylvania's Prudent Investor Rule contained in the Pennsylvania Probate, Estates and Fiduciaries Code as specifically tailored to the investments and fiduciary duties of board members of a public pension plan like SERS.

- Page 85 - IFS recommends that the SERS Board pursue legislation granting the System autonomy in establishing its administrative budget, thereby exempting the System from the budget processes and policies to which all other state agencies (including independent agencies) are subject. IFS provides no conclusive, substantive evidence (despite the fact that we had previously requested the inclusion of such evidence) as to why SERS and PSERS should be the only state agencies exempted from these requirements, which are designed as important safeguards to ensuring proper oversight of the budgets of entities that manage billions of dollars of public pension assets.
- Page 87 – IFS recommends that the SERS Board support legislation to grant the SERS Board the authority to select and contract with its custody bank (perhaps from a list of banks approved by the State Treasurer). However, IFS fails to provide any specific examples of how the current statutory provision providing that the State Treasurer is the custodian of the fund, which resulted in the requirement that the custody bank be selected by the State Treasurer, has proven to be in any way problematic. In fact, IFS acknowledges that the State Treasurer has competitively selected a “top-tier global” custody bank and notes that the current contractual custody arrangement is “uncommon and advantageous given the low flat fee.” These statements appear to entirely undermine IFS’ recommendation that the SERS Board go through the time and expense of pursuing a change to state law. Furthermore, IFS fails to consider that retaining the role of the State Treasurer as the custodian of the fund acts as an important protection to the members of the SERS plan. SERS’ response to this recommendation lends further support to our conclusion that no change to the current process is needed: “As noted, staff currently provides input and suggestions into the existing process and was involved in recent contract negotiations. The Treasurer has historically been sensitive and responsive to the needs of the Fund.”

- Page 89 - IFS recommends that the SERS Board should support legislation to be granted autonomy from procurement and personnel policies to which all other executive branch agencies are subject. IFS provides no conclusive, substantive evidence (despite the fact that we had previously requested the inclusion of such evidence) as to why SERS and PSERS should be the only executive branch agencies exempted from these requirements.
- Page 91 - IFS recommends that the SERS Board adopt rules incorporating more stringent ethics requirements with respect to both conduct and disclosure. We agree with IFS and Chapter 1 of our report recommends that the SERS Board adopt enhanced ethics policies to ensure that the policies properly reflect the fiduciary duties of board members of a public pension plan like SERS.
- Page 95 – IFS recommends that the SERS Board adopt a recusal policy governing circumstances such as receipt of campaign contributions, outside financial interests, and family relationships. This is a reasonable recommendation that is also discussed in Chapter 1 of our report.

Section III – Task Area I-D: Investment Consultants' Responsibilities

This section provides a thorough description of the services provided by SERS' investment consultants and reasonable recommendations for changes that could help SERS more effectively accomplish its mission. We discuss this issue further in Chapter 3 of our report.

Section III – Task Area I-E: Securities Class Action Litigation Activities

IFS provides a detailed overview of the securities class action litigation process and reasonable recommendations for changes that could help SERS more effectively accomplish its mission. Our review of this issue in our audit included testing of the actual monitoring and processing of monies received through litigation settlements. We discuss this issue further in Chapter 5 of our report.

Samuel W. Halpern, President
INDEPENDENT FIDUCIARY SERVICES, INC
August 25, 2006
Page Ten

The Department of the Auditor General appreciates the opportunity to submit these comments on IFS' final SERS Report I. If you have any questions regarding the content of this letter, please feel free to contact Helen A. Weigel, Director, Bureau of Special Performance Audits, at (717) 787-2150.

Sincerely,

A handwritten signature in black ink, appearing to read "Jack Wagner", with a stylized flourish at the end.

JACK WAGNER
Auditor General

cc: Jeanna M. Cullins, Senior Vice President, IFS
Andrew Irving, General Counsel, IFS
Eric Henry, Executive Director, SERS
Leonard M. Knepp, Director, Audits, Reporting & Compliance, SERS
Michael A. Budin, Chief Counsel, SERS

Commonwealth of Pennsylvania
State Employees' Retirement System

*A Special Performance Audit by the
Pennsylvania Department of the Auditor General
September 2006*

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Commonwealth of Pennsylvania
State Employees' Retirement System

A Special Performance Audit by the
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September 2006

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