

September 26, 2006

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Commonwealth of Pennsylvania  
Public School Employees Retirement  
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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 Public School Employees' Retirement System (PSERS). 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 PSERS in 2012 or 2013. According to information provided by PSERS, the contributions from employers—that is, taxpayers—may need to increase five-fold in order to meet future retirement obligations.

The objectives of this engagement were to:

- Evaluate the organizational structure and resources of PSERS to determine if it is effectively accomplishing its mission;
- Review the legal provisions that govern PSERS' investment operations and determine if there are instances in which the provisions may restrict PSERS' independence or hamper its ability to achieve its mission;
- Determine if PSERS' 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 PSERS' 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 PSERS 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 PSERS ensures that potential conflicts of interests are adequately monitored and disclosed by individual board members with the assistance of the PSERS' Board Secretary and PSERS' consultants and managers. In addition, we recommend that the training provided to board members be formalized and that certain improvements be made to the structure of the internal audit operation.

Chapter Two contains recommendations that urge PSERS management to continue to work with the Governor's Office of Administration, Office of Budget and Office of General Counsel in a manner that takes full advantage of the resources that these offices provide. At the same time, PSERS' legal office should continue to be cognizant of any potential conflicts of interest that might exist and be prepared to assist PSERS to obtain independent counsel when necessary. This chapter also includes a recommendation to ensure that all PSERS documents appropriately reflect the PSERS legal office's determination that PSERS' board members are subject to the "prudent investor" standard. The final recommendation in this chapter calls for PSERS to seek a legislative change to the prudence standard outlined in the PSERS 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, PSERS 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. However, we recommend that potential conflicts of interest which may exist between PSERS' general investment advisor and its external financial managers be adequately disclosed to the board. In addition we ask that the process of selecting investment managers be formalized and that enhancements be made to ensure that PSERS adequately monitors contract compliance relative to investment managers.

Chapter Five discusses how PSERS' management can make improvements in how it monitors the securities litigation process. Finally, Chapter Six recommends that management make improvements in how it reports investment in and with Pennsylvania firms to the General Assembly.

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 PSERS with regard to many of these same issues. IFS is also issuing a separate report on other issues regarding PSERS' 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, PSERS faces considerable challenges in the years to come. It is of critical importance that the work begin with the General Assembly and the PSERS Board to take the necessary steps to avoid any future fiscal crisis. It is my hope that the implementation of the 36 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 Public School Employees' Retirement System (PSERS). 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 was the four years beginning January 1, 2001, and ending December 31, 2004. Our fieldwork began April 25, 2005, and ended May 1, 2006.

### **Finding 1.1 – PSERS' 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 PSERS.**

**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 PSERS' 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 Board members who are elected 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 Board 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 firm to Board members within the past ten years to the Board's Secretary each time that consultant or manager has a proposal before the Board so that the Board Secretary can assist Board members in complying with the conflict of interest policy.

**Finding 1.2 – PSERS Did Not Maintain A Formal Training Program For Its Board Members Or Track How Many Hours Of Training Each Board Member Received.**

**Recommendations:** We recommend the following:

- PSERS' staff should develop, with the Board's approval, a formal Board member training policy, including objectives and guidelines for new and existing Board members and their designees to include minimum annual training requirements and associated record-keeping of the training hours each Board member and his/her designee receives. The training program should include basic investment classes for new members and their designees and gradually add intermediate classes and advanced sessions.
- PSERS should offer additional "in-house" educational training sessions provided by PSERS' investment consultants and managers as authorized by contract as well as by PSERS' professional staff, including a review of the prudence standard to which the Board members must adhere.
- Finally, PSERS' Chief Counsel should review whether Section 8501(d) of the PSERS Retirement Code authorizing PSERS to reimburse employers for the time that a Board member who is a member of the plan and employed by a governmental entity is "necessarily" away "to execute the duties of the board" provides PSERS with the necessary authorization to provide reimbursement for the time that a Board member spends at an educational/industry meeting or whether such authorization should be restricted to reimbursement for the attendance at official Board meetings, or other meetings at which all Board members are in attendance. Should the Chief Counsel determine that such reimbursement is authorized by the Retirement Code, PSERS should include a



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provision about such reimbursement in its formal Board member training policy and should also consider requiring Board members who are school employees to, when possible, limit their educational travel to the summer months.

**Finding 1.3 – PSERS’ Internal Audit Office Lacked The Organizational Independence And Staff Resources Necessary To Effectively Complete Audits.**

**Recommendations:** We recommend that:

- PSERS should realign its current organizational structure so that the Internal Audit Office reports both to the Executive Director and to the Board’s Audit Committee. Additionally, the Internal Auditor should periodically update PSERS’ 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;
  - Reviewing with management and the Internal Audit Office 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 most recent edition of the Institute of Internal

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*Auditors' (IIA) International Standards for the Professional Practice of  
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- The Board should conduct a review of the Internal Audit Office to determine the number of audit staff needed to effectively accomplish the office's mission.
- The Board should establish a policy prohibiting the reassignment of internal audit staff to duties that compromise staff members' ability to maintain their independence. The Board should also take steps to ensure that existing internal audit staff is entirely independent of the operations they audit.
- The Internal Audit Office should be required to complete an audit plan on an annual basis and place priority on completing audits of high-risk areas.
- Finally, to strengthen the position of the Internal Audit Office, a charter containing the minimum criteria outlined in the IIA's Standard 1000 should be developed and presented to the Audit Committee and the PSERS Board for approval.

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

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

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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 PSERS’ Independence To Make Investments Or Its Mission.**

**Recommendations:** We recommend the following:

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

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

**Recommendations:** We recommend that:

- PSERS should ensure that all of its documents consistently refer to the “prudent investor” standard, which is the prudence standard to which PSERS’ Chief Counsel has determined the PSERS Board members are subject.
- All PSERS 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 PSERS’ members if they do not meet their obligations.

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**Finding 2.4 – It Is Unclear Whether The Prudence Language In The PSERS 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.**

**Recommendations:** Because PSERS and the PSERS 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 PSERS 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. Alternatively, or in the meantime, PSERS should amend its investment policy accordingly.

The General Assembly should, independent of PSERS, consider amending the PSERS 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 – PSERS’ Procurement Process For The Selection Of Investment Advisory Consultants And Actuarial Services Worked As Intended.**

**Recommendation:** - No recommendation necessary.

**Finding 3.2 – PSERS’ Investment Advisory Consultants And Actuary Complied With Their Contractual Obligations.**

**Recommendation:** - No recommendation necessary.

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**Finding 3.3 – PSERS Staff Did Not Disclose Relationships Between PSERS' General Investment Advisory Consultant And External Financial Managers To The Board.**

**Recommendations:** We recommend that PSERS' staff continue to require investment managers to report any relationships they have with PSERS' investment consultants. Additionally, information regarding any potential conflicts of interest and business relationships between the investment managers and the general investment advisory consultant should be disclosed to the PSERS Board members prior to their voting on an investment manager.

**Finding 4.1 – While PSERS' Due Diligence Process For Selecting Investment Managers Appears Adequate, PSERS Did Not Have Formal Policies And Procedures.**

**Recommendation:** We recommend that PSERS develop formal due diligence policies and procedures. At a minimum, these written policies and procedures should include all requirements and steps in the due diligence process to ensure that the due diligence performed allows PSERS' Board members to make, and support, informed decisions and fulfill their fiduciary duties.

**Finding 4.2 – PSERS Did Not Adequately Monitor Its Investment Managers' Compliance With Their Contracts.**

**Recommendations:** PSERS' Investment Office's Risk and Compliance Division should improve its investment manager performance monitoring and report/documentation compliance by:

- Revising and formalizing, in writing, all existing policies and procedures pertaining to all aspects of investment manager performance and compliance. At a minimum, these written policies and procedures should include:
  - Specific steps for each process (e.g., on-site visits, *Investment Monitor* reports, quarterly compliance reporting, underperforming firms, and internal account reviews) employed in monitoring investment management firms and internal portfolio managers;

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- Steps for obtaining and retaining contractually required documents; and
  - Date the policy was adopted by the Board and, if applicable, the date of any amendments;
  - Fully programming *Investment Monitor* and utilizing the software to its fullest capacity; and
  - Obtaining and retaining copies of all contractually required documentation, including but not limited to current errors and omission insurance and fidelity bond insurance.

**Finding 4.3 – PSERS Reviewed And Approved Investment Manager Invoices Correctly.**

**Recommendation:** No recommendation is necessary.

**Finding 5.1 –PSERS Was Unable To Provide Case-Specific Monitoring Of The Securities Litigation Process Due To Inadequate Procedures And A Lack Of Documentation.**

**Recommendations:** We recommend that:

- PSERS enhance its securities litigation procedures to include details specifically outlining the roles and responsibilities of all staff and third parties involved in the process;
- PSERS' staff should provide the Board with additional securities litigation information, such as investment losses, so that the Board has a complete and accurate representation of the significance of each settlement and can exercise appropriate oversight;
- PSERS Board formally adopt a charter for the Corporate Governance Committee;

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- PSERS obtain monthly reports from the custodian bank, that list the details for each securities litigation claim filed with a claims administrator; and
- PSERS periodically obtain, from a third party, an audit of the custodian bank to ensure that all monies owed to PSERS have been accounted for properly.

**Finding 6.1 – PSERS Did Not Present Information To The General Assembly That Clearly Indicated The Amount PSERS Invested In Pennsylvania.**

**Recommendations:** We recommend that PSERS clarify information on investments in Pennsylvania that is provided in the budget reports submitted to the General Assembly by:

- Including the amount, when possible, of the Pennsylvania-based managers portfolios that are actually invested in Pennsylvania companies or real estate;
- Indicating the amount of the commitment to real estate managers that has been funded;
- Including the year of commitment, the amount committed, the amount funded, and the amount returned on alternative investments;
- Including the internally tracked information on alternative investments such as the number of Pennsylvania companies PSERS invested in and the total number of persons employed with these companies;
- Precisely stating how much of the total market value listed for Pennsylvania-based managers is also included in the total for that particular asset class; and
- Including the return-on-investment for Pennsylvania investments versus all investments by PSERS.

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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.”<sup>1</sup>*

---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 Public School Employees' Retirement System (PSERS), a defined benefit public pension plan for the four-year period beginning January 1, 2001, and ending December 31, 2004. This performance audit was conducted by the Department's Bureau of Special Performance Audits. Fieldwork for the audit began on April 25, 2005, and ended 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 PSERS**

PSERS was established by Act 343 of 1917 to provide benefits to teachers and other employees of the public schools (e.g., school district administrative support staff) of the Commonwealth of Pennsylvania. PSERS is a governmental cost-sharing multi-employer defined benefit pension plan and is considered a component unit of the Commonwealth of Pennsylvania's executive budget. PSERS' operations are governed by the Public School Employees' Retirement Code (Retirement Code).<sup>2</sup> Other state and federal statutes also impact PSERS operations.

PSERS Mission Statement reads:

The Board of Trustees and the employees of the Public School Employees' Retirement System serve the members and stakeholders of the system by:

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

<sup>2</sup> See 24 Pa.C.S § 8101 *et seq.*



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- Prudently investing the contributions of the fund;
  - Maintaining a financially sound fund;
  - Providing timely and accurate payment of benefits;
  - Clearly communicating members' and employers' rights and responsibilities; and
  - Effectively managing the resources of the system.

The Public School Employees' Retirement Board (Board) was established by law as an independent administrative board,<sup>3</sup> and exercises control and management of the Public School Employees' Retirement System (System), including the investment of its assets.

Teachers and other public school employees eligible to participate in PSERS' plan, which is funded through employee and school district contributions and returns on investments, include all full-time public and part-time teachers and other public school employees who work at least 80 days or 500 hours of service yearly. As of June 30, 2005, the plan had approximately 255,000 public school employees who were active members of PSERS.<sup>4</sup>

The chart in Figure 1 tracks the ratio of PSERS' actuarial asset values to its actuarial liabilities. We note that the funded ratio has gone down in recent years, from a high of 114.4% in 2001 to 84.6% in 2005.

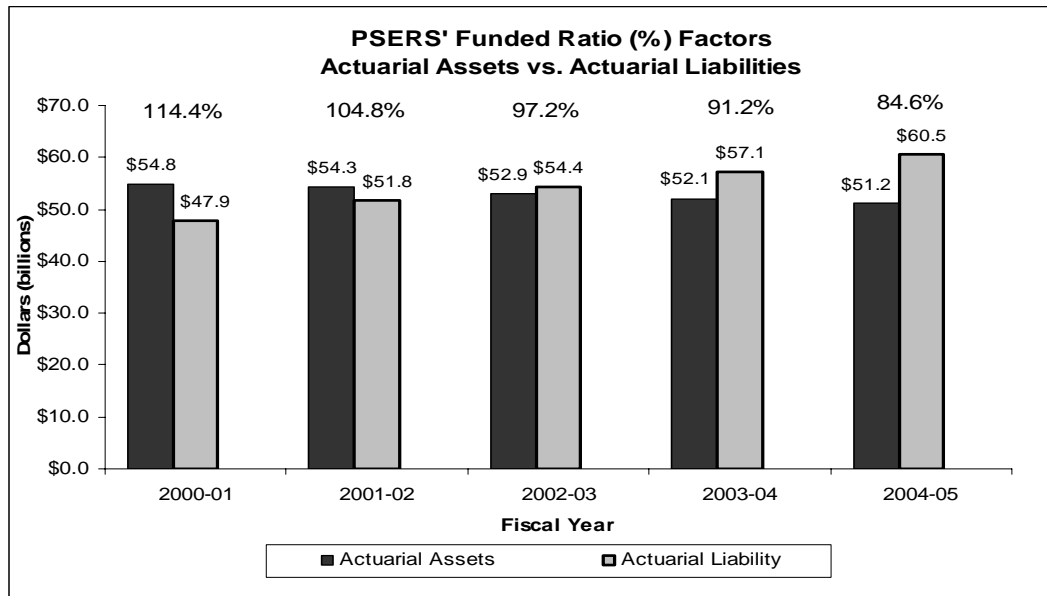
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<sup>3</sup> 24 Pa.C.S. § 8501(a).

<sup>4</sup> *Just the Facts*, <http://www.psers.state.pa.us/org/facts.htm>, last updated June 30, 2005, accessed September 11, 2006.

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**Figure 1 - PSERS' Funded Ratios<sup>5</sup>**



<sup>5</sup> Data compiled from PSERS' actuary reports.

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The following table reflects projections of retirees and active employees through the year 2014 made by PSERS' actuary:

**Table 1. Annuitants and Employees<sup>6</sup>**

Calendar Year	Total Retiree and Survivor Lives	Active Employees
2006	166,552	247,901
2007	173,871	247,901
2008	181,393	247,901
2009	189,013	247,901
2010	196,323	247,901
2011	203,287	247,901
2012	210,072	247,901
2013	216,578	247,901
2014	222,723	247,901

**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 PSERS as it strives to exceed the rate of return assumed by PSERS' actuaries. This audit of the investment operations of PSERS 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 PSERS at this time is that public school districts will be confronted with a dramatically increased employer contribution rate within the next five to six years. In fact, as shown in Table 2, PSERS has projected that the employer contribution rate will increase four-to-five fold by 2013.

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<sup>6</sup> PSERS' 2005 Comprehensive Annual Financial Report, December 1, 2005, p. 106.

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**Table 2. Projection of PSERS' Employer Contributions<sup>7</sup>**

<b>Fiscal Year Ending 6/30</b>	<b>Total Employer Rate %</b>
2006	4.69
2007	6.46 <sup>8</sup>
2008	7.15
2009	6.78
2010	5.83
2011	5.50
2012	5.46
2013	22.52
2014	21.57
2015	20.24

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 2001<sup>9</sup> and 2002<sup>10</sup> to increase employee retirement benefits at a time when economic conditions appeared favorable enough to allow for such increases without any negative consequences.

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<sup>7</sup> PSERS' 2005 Actuary Report, p. 20.

<sup>8</sup> The PSERS Board adopted this employer contribution rate on December 9, 2005.

<sup>9</sup> Act 9 of 2001 provided for the following with regard to PSERS: 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; 3) the addition of a new class with contribution rates increasing effective on or after January 1, 2002, for those members electing the new class, from 5.25% to 6.50% and for those members hired after July 1, 1983, increasing from 6.25% to 7.50%; and 4) restructured payments intended to pay for unfunded accrued liabilities.

<sup>10</sup> 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 established 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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- A significant downturn in the economy beginning in late 2001 until the end of 2003 impacted the investment markets and, in turn, led to investment losses for PSERS.<sup>11</sup>
  - Following PSERS' investment losses, employer contributions to PSERS 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.<sup>12</sup>
  - When it became apparent that this would result in an immediate and significant gap in fund liabilities to available assets, legislation<sup>13</sup> 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.

PSERS (like the State Employees' Retirement System (SERS)), 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.<sup>14</sup> For example, on September 1, 2005, PSERS and SERS wrote the Secretary of the Budget a comprehensive letter providing him with

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<sup>11</sup> September 1, 2005 joint letter from the Executive Directors of PSERS and SERS to Michael J. Masch, Secretary of the Budget, p. 1.

<sup>12</sup> See Act 38 of 2002.

<sup>13</sup> Act 40 of 2003 provided as follows: 1) beginning July 1, 2004, increased the minimum employer contribution rate from 1 percent to 4 percent; 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.

<sup>14</sup> 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 PSERS' pension fund, it is important to take this opportunity to assist PSERS (and SERS) in its efforts to shed a spotlight on this issue so that policymakers may take appropriate action to help achieve the stability of PSERS' (and SERS') 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 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)).

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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."<sup>15</sup> 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.<sup>16</sup> We urge the Boards, the Governor, and the General Assembly to work together to address this critical issue that will soon impact the PSERS and SERS retirement plans.

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<sup>15</sup> September 1, 2005 joint letter from the Executive Directors of PSERS and SERS to Michael J. Masch, Secretary of the Budget, p. 2.

<sup>16</sup> 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 Public School 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 was the four-year period beginning January 1, 2001 and ending December 31, 2004. Fieldwork began on April 25, 2005 and ended May 1, 2006.

Our audit objectives consisted of the following:

- To evaluate the organizational structure and resources of PSERS to determine if it is effectively accomplishing its mission.
- To review the legal provisions that govern PSERS' investment operations and determine if there are instances in which the provisions may restrict PSERS' independence or hamper its ability to achieve its mission.
- To determine if PSERS' 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 PSERS' 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.

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

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

In April 2005, the Department of the Auditor General, PSERS, and SERS 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 PSERS and SERS. IFS is a nationally recognized consulting firm with experience examining the operations of 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 systems’ 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 PSERS’ 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 PSERS, which includes



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comments from both PSERS 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 PSERS and the Department.

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## **Chapter One      Organizational Structure and Resources**

Since 1917, the Public School Employees' Retirement System has been providing pension plan services to the public school employees of the Commonwealth of Pennsylvania. PSERS' membership has grown to more than 470,000 active and retired members as of June 2006.

The PSERS Board is comprised of 15 members who stand in a fiduciary relationship to the PSERS plan members regarding the investments and disbursements of the PSERS fund (Fund).<sup>17</sup> It is an "independent administrative board"<sup>18</sup> which is ultimately responsible for managing the day-to-day operations of the System. The Board receives assistance in fulfilling its responsibilities from the PSERS' staff, consultants, and investment managers.

The members of the PSERS Board, as trustees of the Fund,<sup>19</sup> have exclusive control and management of the Fund and full power to invest the Fund, subject to meeting the prudence standard to which they are subject under Section 8521(a) of the Retirement Code.<sup>20</sup> 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 PSERS' organizational structure to determine whether it has

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<sup>17</sup> 24 Pa.C.S. § 8521(e). The Retirement Code does not contain a definition of the term "Fund." However, Section 8522 of the Retirement Code, 24 Pa.C.S. § 8522, provides as follows: "The fund shall consist of all moneys in the several separate funds in the State Treasury 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 83 (relating to membership, contributions and benefits) and all earnings from investments or moneys of said fund."

<sup>18</sup> 24 Pa.C.S. § 8501(a).

<sup>19</sup> Section 8521(a) of the Retirement Code, 24 Pa.C.S. § 8521(a), provides, in pertinent part, as follows: "The members of the board shall be trustees of the fund."

<sup>20</sup> 24 Pa.C.S. § 8521(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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all of the essential elements for a well-functioning pension plan for public school employees whose Board members have a fiduciary duty to invest and manage its monies for the exclusive benefit of its members.

**Objectives and Methodology**

Our objective was to evaluate the organizational structure and resources of PSERS 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 PSERS 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 PSERS' mission statement, written policies and procedures, and other documentation pertaining to PSERS' day-to-day operations;
- Reviewed the Comprehensive Annual Financial Reports and budgetary reports for fiscal years ended June 30, 2001, 2002, 2003, 2004, and 2005;
- Reviewed all 45 PSERS Board meeting minutes for the audit period and observed all 10 Board meetings held during audit fieldwork, to ensure that Board processes and procedures are conducted in accordance with governing policies;
- Reviewed all 264 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 25 individual Board members who served on the PSERS Board during the audit period to evaluate their backgrounds in investment and finance;

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- Reviewed documentation of Board member training to determine its appropriateness and sufficiency;
  - Evaluated how the Board and individual Board members dealt with potential conflicts of interest under the Public Official and Employee Ethics Act (Ethics Act);<sup>21</sup>
  - Interviewed 13 Board members;<sup>22</sup>
  - 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 PSERS' organization chart to determine the Internal Auditor's independence;
  - Tested all 14 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
  - Evaluated the Board's Audit Committee to determine if it 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 PSERS' governance documents, Board and committee structure, information technology as it relates to investments, and PSERS' Internal Audit Office. We reviewed and tested Board ethics and conflict of interest matters, Board training and continuing education, and the independence of PSERS' internal audit function. Accordingly, taken together, both reports provide a comprehensive perspective on PSERS' organizational structure and resources.

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<sup>21</sup> 65 Pa.C.S. § 1101.1 *et seq.*

<sup>22</sup> We interviewed 13 of the 15 Board members who were serving on the Board at the time of our audit field work.

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Except where noted below, we have concluded that PSERS Board and staff have generally fulfilled PSERS' stated mission to prudently invest assets, maintain a financially sound plan, and effectively manage resources. Furthermore, we note that PSERS has received awards and made achievements in the public pension fund arena, including, for example, in 2005 becoming one of 51 public pension plans nationwide to receive the Public Pension Coordinating Council's Public Pension Standards award. This award is presented in recognition of the attainment of the Council's professional standards for plan design and administration.

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

- PSERS 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 PSERS;
- PSERS' did not maintain a formal training program for its Board members or track how many hours of training each Board member received; and
- PSERS' Internal Audit Office lacked the organizational independence and staff resources necessary to effectively complete audits.

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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 PSERS 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 8521(e) of the PSERS Retirement Code,<sup>23</sup> 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. PSERS Board members are held to the provisions of the Ethics Act<sup>24</sup> in addition to the Governor's Code of Conduct<sup>25</sup> or the Legislative Code of Ethics (Legislative Code),<sup>26</sup> as applicable depending upon the roles they play within their professional capacities within Commonwealth government.

Due to the nature of the investment culture, in which investment companies spawn consultants, and in which 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 interests of the PSERS 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 2006; and

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<sup>23</sup> 24 Pa.C.S. § 8521(e).

<sup>24</sup> 65 Pa.C.S. § 1101.1 *et seq.*

<sup>25</sup> 4 Pa. Code § 143.1 *et seq.* (Executive Order 1980-18, as amended).

<sup>26</sup> 46 P.S. § 143.1 *et seq.*

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

**Finding 1.1 – PSERS’ 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 PSERS.**

PSERS’ *Statement of Organization, Bylaws, and Other Procedures of the Commonwealth of Pennsylvania Public School Employees’ Retirement Board* (Bylaws), adopted in 1991, states the following:

Any member of the Board who would be required to vote on a matter that would result in a conflict of interest should abstain from voting, refrain from participating in any discussion concerning the matter, and, prior to the vote being taken, publicly announce and disclose the nature of his/her interest as a matter of public record in a written memorandum filed with the Executive Director or acting secretary of the meeting, except that such a memorandum may be filed after the vote is taken if the conflict does not become apparent to the Board member within a reasonable period of time prior to such vote.<sup>27</sup>

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 PSERS’ Bylaws essentially 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”<sup>28</sup> requires such egregious and clear-cut violations that the provision does not adequately

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<sup>27</sup> *Statement of Organization, Bylaws, and Other Procedures of the Commonwealth of Pennsylvania Public School Employees’ Retirement Board*, adopted January 25, 1991, revised on September 24, 2004, p. 27.

<sup>28</sup> 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.”

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encompass the standards that should be applicable to pension plan trustees with fiduciary duties.<sup>29</sup> 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.<sup>30</sup>

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 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 PSERS 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.<sup>31</sup> 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.<sup>32</sup> APPFA

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<sup>29</sup> 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.”

<sup>30</sup> Section 1103(c) of the Ethics Act, 65 Pa.C.S. § 1103(c), prohibits a public official from accepting improper influence stating 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.]

<sup>31</sup> 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. PSERS has been a member of APPFA for more than ten years.

<sup>32</sup> “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 government business or retaining a government contract. 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



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designed the policy to foster unquestioned public confidence that public pension plans operate with integrity and prudence.

It is vital that the PSERS 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 PSERS Board in order to identify the existence of actual or perceived “conflicts of interest” should be a shared responsibility by the PSERS Board members as well as their consultants and managers.

During our audit period, PSERS Board members who are elected officials received campaign contributions from investment management, law, brokerage, accounting, and other firms that had business dealings with PSERS. 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 actions<sup>33</sup> and neither the Ethics Act nor PSERS’ Bylaws contain a monetary threshold amounts for required disclosure, these contributions 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 PSERS.<sup>34</sup>

Although we observed Board members properly recusing themselves from votes in accordance with the Ethics Act and PSERS’ Bylaws, a review of meeting minutes within the audit period showed that, in 11 of 14 recusals during Finance Committee

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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.

<sup>33</sup> 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 there from.

<sup>34</sup> 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 PSERS’ Bylaws.

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meetings and in 13 of 13 recusals during Board meetings, public announcements of reasons for recusal were not recorded, in violation of the Board's Bylaws. Therefore, the vast majority of meeting minutes fail to reveal why a Board member abstained from voting.

In addition, there were instances in which Board meeting minutes revealed that members may have been uncertain or may have misunderstood when it is necessary for them to recuse themselves from voting under the provisions of both the Ethics Act and PSERS' Bylaws. In fact, at one Board meeting, the Board held a discussion regarding whether campaign contributions of a certain dollar amount or more should require an automatic recusal. However, because the Board could not reach a consensus on the issue, the matter was removed from Board consideration at that time.

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's moneys for the exclusive benefit of the plan members make it imperative for the Board to strive for greater transparency regarding campaign contributions.<sup>35</sup> 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, PSERS Board should establish standards that go considerably beyond ensuring compliance with minimum statutory requirements. The 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 PSERS' independence and integrity.

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<sup>35</sup> 24 Pa.C.S. § 8521(e).

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**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 PSERS' 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 Board members who are elected 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 Board 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 has a proposal before the Board so that the Board Secretary can assist Board members in complying with the conflict of interest policy.

**PSERS' Response**

The Board will consider this finding and the accompanying recommendations. In doing so and, as noted in its response to the IFS recommendation on this topic [IFS Report I, Section C-9], "the Board is well aware of its need to maintain the highest ethical and fiduciary standards as it serves the members of the System. This includes not only avoidance of actual impropriety, but also the perception of impropriety. It

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also includes strict adherence to the existing statutory and/or regulatory requirements applicable to the Board in this area.” Therefore, the Board will continue to meet not only the existing ethical standards applicable to the Board, but also the higher fiduciary standards imposed by the Public School Employees' Retirement Code (PSERC). Indeed, Article V, Section 5.11 of the Board's Statement of Organization, Bylaws, and Other Procedures (Bylaws), which sets forth the Board's current recusal policy for conflicts of interests, specifically notes that, in addition to the State Ethics Laws requirements governing recusals, Board members also are governed by their higher fiduciary duties/standards. Finally, with respect to the issue of campaign contributions, the Board notes that IFS concluded that PSERS' existing provisions governing this area contained in Article VI, Section 6.3 of the Bylaws are “a good start at addressing” this national issue.

**Department of the Auditor General's Comments on PSERS' Response**

The Department of the Auditor General is pleased that PSERS will consider our recommendations and we strongly encourage their implementation. The Department also acknowledges the efforts that PSERS indicates are currently being made by PSERS and its Board members to avoid conflicts of interest. In its response, PSERS points out that IFS identified certain provisions in its existing Bylaws as “a good start at addressing” conflicts of interest. What PSERS does not mention is that IFS goes on to state that these provisions do not apply to the Governor or the legislative leaders who have the authority to appoint six Board members. Although all public officials must adhere to the highest ethical standards to ensure that they avoid conflicts of the interest, elected officials serving on a public board inherently carry the strongest burden due to the receipt of campaign contributions that tend to trigger such conflicts.

Furthermore, we note that even the *appearance* of a conflict of interest can have serious repercussions for the confidence and trust that PSERS' members and the public have in the integrity of the PSERS Board as a whole. Therefore, as outlined in our recommendations, it is in the best interest of PSERS and the PSERS 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 PSERS and the PSERS Board undertake steps to ensure that the PSERS Board Secretary and the Board's consultants and managers assume responsibility for helping

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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 continuing education for PSERS Board members and their designees 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 and their designees 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 PSERS. Therefore, appropriate orientation of new Board members and appropriate training is essential.

A July 2000 report, entitled *Public Pension Systems: Statements of Key Investment Risks and Common Practices to Address Those Risks*, endorsed by the Government Finance Officers Association (GFOA),<sup>36</sup> 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.<sup>37</sup>

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<sup>36</sup> The Government Finance Officers Association provides education, resources, and networking opportunities to support high standards in finance for governmental entities.

<sup>37</sup> 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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For this aspect of the audit, we performed the following:

- Reviewed Board member orientation packets and documentation related to the actual orientation each new Board member should have received;
- Reviewed PSERS Board education policies and procedures; and
- Reviewed Board member records of all trips taken to attend educational/industry meetings during the audit period to ensure compliance with PSERS' Travel and Education Policy.

**Finding 1.2 – PSERS Did Not Maintain A Formal Training Program For Its Board Members Or Track How Many Hours Of Training Each Board Member Received.**

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

Based on our audit test work, we determined that all new PSERS Board members and their designees are given a complete orientation packet that can be used as a helpful reference manual while serving on the Board. In addition, all new Board members and their designees, regardless of previous investment experience, are provided with an orientation session that includes an overview of the System's history and Board member duties and responsibilities as fiduciaries.<sup>38</sup> Therefore, it appears that PSERS is providing its new Board members and their designees with adequate orientation when they join the Board.

However, for our four-year audit period, although some Board members and their designees attended educational/industry meetings, we found no evidence that PSERS maintains a formal training program for its Board members and designees. In fact, our

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<sup>38</sup> All PSERS Board members and their designees have the option of attending such orientation sessions regardless of how long they have been serving on the Board.

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review indicated that PSERS does not have a formal training policy and does not track how many hours of training each Board member/designee receives.

PSERS' Travel and Education Policy, which applies to all Board members and their approved designees, outlines the number of domestic and international periodic and annual educational/industry meetings that each PSERS Board member and designee may receive approval to attend.<sup>39</sup> The policy incorporates Section 6.3(c) of PSERS' Bylaws, which provides that PSERS Board members are "to be reimbursed by the Board for the reasonable and necessary expenses of attending to Board business."<sup>40</sup> However, the policy contains neither training objectives nor requirements, including the minimum annual training hours each Board member or designee must receive, nor a method for keeping records of how much training each Board member/designee receives. The policy also does not address the Board's practice of reimbursing school districts for the time Board members employed by the districts were away attending meetings during the school year.<sup>41</sup>

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<sup>39</sup> *Travel and Education Policy of the Commonwealth of Pennsylvania Public School Employees' Retirement Board*, adopted November 1, 1996. The policy allows for a Board member to be reimbursed for any costs incurred for attendance of not more than three pre-approved educational/industry meetings per year, two annual educational/industry meetings per year, and not more than one international meeting every two years during their term. The policy requires that a Board member's attendance at an international meeting must be specifically approved by the Board "prior to departure."

<sup>40</sup>Ibid, p. 5.

<sup>41</sup> We found that PSERS reimbursed the school districts a total of \$57,271 for the time that Board members spent away from their school districts to attend educational/industry meetings, which do not necessarily include Board member training sessions, over the four-year audit period. PSERS reportedly relies upon Section 8501(d) of the PSERS' Retirement Code, 24 Pa.C.S. § 8501(d), to justify such reimbursement. That provision states as follows, in pertinent part: "Members of the board who are members of the system and who are employed by a governmental entity shall not suffer loss of salary or wages through serving on the board. The board, on request of the employer of any member of the board who is an active professional or nonprofessional member of the system, may reimburse such employer for the salary or wages of the member, or for the cost of employing a substitute for such member, while the member is **necessarily** absent from employment **to execute the duties of the board.**" [Emphases added.] However, the intent of this provision may be to only allow an employer to be reimbursed for the time that a Board member is away to perform his/her official duties (i.e., the attendance of a Board meeting, the attendance of a meeting attended by all Board members, or the attendance of a Board-approved training course) and not for the attendance of an educational/industry meeting that may or may not include Board member training.



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We learned through our test work that PSERS' Board members and their designees generally participated in at least one educational/industry meeting during our four-year audit period. Furthermore, our review of materials from the educational/industry meetings that PSERS Board members attended both domestically and internationally appear to indicate that the meetings offered some educational opportunities for PSERS Board members. However, despite the fact that PSERS' contracts with its investment consultants and managers allow for them to provide educational presentations to the Board, PSERS did not take adequate advantage of such opportunities during the audit period.<sup>42</sup>

PSERS' training program should be more formally organized and developed to ensure that specific training objectives and goals are clearly identified and attained. PSERS should adopt a formal training policy that identifies basic investment classes initially provided to new members and their designees, gradually includes intermediate classes, and ultimately provides advanced investment classes/presentations. Finally, PSERS' formal training policy should include the minimum level of annual training each Board member and his/her designee is expected to obtain and address PSERS' current practice of reimbursing school districts for the time Board members employed by the districts are away attending educational/industry meetings during the school year.

**Recommendations**

We recommend the following:

- PSERS' staff should develop, with the Board's approval, a formal Board member training policy, including objectives and guidelines for new and existing Board members and their designees to include minimum annual training requirements and associated record-keeping of the training hours each Board member and his/her designee receives. The training program should include basic investment classes for new members and their designees and gradually add intermediate classes and advanced sessions.

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<sup>42</sup> Please note that, since the end of our audit period, PSERS' staff has conducted a training session for Board members prior to one of its Board meetings that was reportedly very well received by the Board members. PSERS has indicated that it plans to continue providing such training at least once or twice each year.

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- PSERS should offer additional “in-house” educational training sessions provided by PSERS’ investment consultants and managers as authorized by contract as well as by PSERS’ professional staff, including a review of the prudence standard to which the Board members must adhere.<sup>43</sup>
  - Finally, PSERS’ Chief Counsel should review whether Section 8501(d) of the PSERS Retirement Code authorizing PSERS to reimburse employers for the time that a Board member who is a member of the plan and employed by a governmental entity is “necessarily” away “to execute the duties of the Board”<sup>44</sup> provides PSERS with the necessary authorization to provide reimbursement for the time that a Board member spends at an educational/industry meeting or whether such authorization should be restricted to reimbursement for the attendance of official Board meetings, other meetings at which all Board members are in attendance and approved training courses. Should the Chief Counsel determine that such reimbursement is authorized by the Retirement Code, PSERS should address such reimbursement in its formal Board member training policy and should also consider requiring Board members who are school employees to, when possible, limit their educational travel to the summer months.

**PSERS’ Response**

The Board will consider this finding and the accompanying recommendations. As noted in its response to the IFS recommendation on this topic [IFS Report I, Section C-10], “PSERS’ Policy Review Agency Committee, which consists of staff and a number of Board members, is in the process of reviewing and, when appropriate, revising all of PSERS policies, including the Board’s current Travel and Education Policy. At present, it is anticipated that the Board will consider a revised Board Education Policy before the end of this year.” The suggestions made by both the Auditor General and IFS will be considered, in depth, at that time. In doing so, however, the Board notes that it does provide multiple educational opportunities for all Board members on the wide variety of

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<sup>43</sup> See a further discussion of this issue in Findings 2.3 and 2.4 in Chapter 2 of this report.

<sup>44</sup> 24 Pa.C.S. § 8501(d).

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topics applicable to operating a large public pension system such as PSERS. These include a comprehensive orientation program for new and existing Board members and their designees, (which was deemed acceptable by the Auditor General), formal in-house training sessions, e.g. semi-annual educational seminars, and topic specific presentations by PSERS' consultants for matters before the Board, e.g. basics of actuarial valuation (December 2004), review of global macro investment strategies, (November 2005), overview of Medicare Part D (September 2005) and, most recently Wilshire's presentations on commodities and currency hedging (June 2006). In addition, Board members are permitted to attend educational programs outside of PSERS, subject to the terms and conditions of the Board's Travel and Educational Policy (Policy), which requires an annual report of each Board member's educational activities in accordance with the Policy. As a result and in keeping with its fiduciary obligations, PSERS does have a multi-faceted training program for its Board members that has resulted in a well educated Board capable of overseeing all aspects of a large and complex public pension plan, including its investment operations, pension benefits administration, health care plan administration and the underlying supporting operations, e.g. information technology.

**Department of the Auditor General's Comments on PSERS' Response**

The Department of the Auditor General is pleased that PSERS is considering our recommendations and we would strongly encourage their implementation. Our report acknowledges PSERS' orientation program for new Board members and designees. Our report also notes that PSERS' Board members and their designees generally participated in at least one educational/industry meeting during our four-year audit period.

However, our test work and the reference in PSERS' response to semi-annual in-house educational seminars and in-house topic specific presentations that were held just one time during our audit period, which ended December 31, 2004,<sup>45</sup> make it apparent that PSERS did not take adequate advantage of offering in-house training sessions

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<sup>45</sup>The Department of the Auditor General is pleased that PSERS has conducted at least three other such seminars and presentations in the recent past and hope that PSERS will continue such efforts.

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presented by staff, investment managers, and investment consultants. We are hopeful that PSERS will formally address this in the educational policy it is revising.

Other critical elements that should be included in the policy to ensure that the training can be tailored to each Board member on the basis of their investment backgrounds are as follows: 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 in-house and outside training opportunities. Such a policy would allow all PSERS Board members, regardless of their prior investment experience, to meet the Board's minimum annual training requirement without hampering each individual Board member's ability to choose sessions/courses at the level of difficulty he or she requires, and would also provide PSERS with a comprehensive record of Board members' education and training.

Because PSERS did not address the issue of reimbursing the school districts, we reiterate our recommendation that PSERS should, with the assistance of its Chief Counsel, determine whether the Public School Employees' Retirement Code authorizes PSERS to reimburse school districts for the time Board members employed by the districts are away to attend an industry meeting and address this issue in the education policy it is developing as necessary.

**IFS' Response**

IFS did not respond to this finding.

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**PSERS' Internal Audit Function**

The purpose of our review of PSERS' 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 staff during the audit period;
- Policies, procedures, practices, and other pertinent information used by PSERS' Internal Audit Office; and
- All 14 audits that were completed by the Internal Audit Office during our audit period.

Our review of the above documents disclosed that the Internal Audit staff complied with continuing education requirements needed to maintain professional certifications. Also, we noted that the objective of PSERS' Internal Audit Office is to minimize PSERS' exposure to risk through effective management processes and procedures. 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 bring a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.<sup>46</sup>

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<sup>46</sup> Institute of Internal Auditors, *International Standards for the Professional Practice of Internal Auditing*.

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PSERS' Internal Audit Office joined the Association of Public Pension Fund Auditors in 1992. Although APPFA does not require its members to abide by IIA standards, it does recommend following IIA standards in its' proposed internal audit charter.

The responsibilities of PSERS' 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.

**Finding 1.3 - PSERS' Internal Audit Office Lacked The Organizational Independence And Staff Resources Necessary To Effectively Complete Audits.**

During our audit period, we found that PSERS' 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.

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As noted in the IIA Standards, the independence of the internal audit function is of utmost importance if this audit function is to effectively accomplish its mission.<sup>47</sup> We found, however, that the Internal Audit Office lacked sufficient organizational independence.

During the audit period, PSERS' Internal Auditor reported directly to the Executive Director, who had the responsibility of completing the Internal Auditor's performance evaluation. In our opinion, this organizational reporting structure could impair the independence and ability of the Internal Audit Office to report all audit findings, both positive and negative, in audit reports, especially findings relating to the operations of the Executive Director's office.

Our review also disclosed that the PSERS Internal Audit Office was unable to adequately plan for and complete internal audits because audit staff was consistently assigned duties unrelated to the internal audit function.<sup>48</sup> In addition, the Internal Audit Office was chronically short-staffed for all but three months of our four-year audit period.

Additionally, much of the work completed by the Internal Auditor dealt more with unrelated consulting services than with completing internal audit tasks. For

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<sup>47</sup>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.

<sup>48</sup> For example, auditors hired by the Internal Audit Office were routinely assigned to work on projects not related to internal audits. In March 2001, the internal staff auditor the sole auditor to report to the Internal Auditor was selected to work on the Commonwealth's SAP project (an ongoing executive branch initiative for streamlining and standardizing on-line systems for accounting, budgeting, payroll, human resources, and procurement) and accepted a permanent position with this program. Another assistant, hired in August 2001, was reassigned three months later to assist with the development of PSERS' new computer-based benefits administration project. This staff auditor did not return to the Internal Audit Office until January 2006. Because the auditor assisted with the development of the new software system, her ability to complete independent audits of operations she helped establish has been compromised.

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example, the Internal Auditor provided assistance with calculating individual retirement benefits, completing tax returns, developing procedures for tracking overpayments for deceased annuitants, and working with the actuarial consultant to develop a method to calculate final average salaries for plan members. The Internal Auditor's involvement in these projects not only decreased the time he had to spend on internal audits, but also potentially impaired his ability to independently audit those areas.

IIA Standard 2010 states that the chief audit executive should effectively manage the internal audit activity to ensure it adds value to the organization. This section of the Standards notes that the planning of internal audit engagements should be based on a risk assessment undertaken at least annually. PSERS' Internal Audit Office last completed a comprehensive audit plan in February 2001. This plan included risk assessment ratings of high, medium, or low for 107 separate audit areas.

The February 2001 audit plan also identified 52 potential audit areas as high risk. However, during our entire four-year audit period only 14 audits were conducted addressing 7 high-risk areas and the other 7 areas were identified as medium risk. This relatively small number of completed audits resulted from understaffing and the reassignment of existing internal audit staff to other duties.

We also found that PSERS Internal Audit Office operated without an approved charter during our four-year audit period. A charter would strengthen and formalize the position of the Internal Audit Office by receiving the full endorsement of the Board. Additionally, a charter would assist in outlining the specific duties and responsibilities assigned to the Internal Auditor and would provide additional accountability.

This is consistent and in furtherance of IIA Standard 1000, which provides that the purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with standards and as approved by the board. The Standards also state that the charter should include the internal audit division's mission statement and statements on accountability, independence, responsibility, authority, and standards of audit practice.

IFS shares our concern regarding the independence of the Internal Auditor. In fact, IFS concluded that PSERS utilized its Internal Audit Office primarily as a



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troubleshooter and, for the future, the purpose of Internal Audits should be more in line with monitoring the internal control processes to provide assurance to management<sup>49</sup>.

**Recommendations**

We recommend that:

- PSERS realign its current organizational structure so that the Internal Audit Office reports both to the Executive Director and to the Board's Audit Committee. Additionally, the Internal Auditor should periodically update PSERS 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;
  - Reviewing with management and the Internal Auditor Office 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 most recent edition of IIA Standards.

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<sup>49</sup> See IFS' PSERS Report I, Section I-A, "Organizational and Management Structures and Resources," p. 45

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- The Board should conduct a review of the Internal Audit Office to determine the number of audit staff needed to effectively accomplish the office's mission.
  - The Board should establish a policy prohibiting the reassignment of internal audit staff to duties that compromise staff members' ability to maintain their independence. The Board should also take steps to ensure that existing internal audit staff is entirely independent of the operations they audit.
  - The Internal Audit Office should be required to complete an audit plan on an annual basis and place priority on completing audits of high-risk areas.
  - Finally, to strengthen the position of the Internal Audit Office, a charter containing the minimum criteria outlined in the IIA's Standard 1000 should be developed and presented to the Audit Committee and the PSERS Board for approval.

**PSERS' Response**

The Board will consider this finding and the accompanying recommendations. It should be noted that although PSERS' organizational documents may show the Internal Audit Office reporting solely to the Executive Director, in practice, the Office has full access to not only the Board's Audit/Budget Committee, but also the full Board. Indeed, this access is noted as part of the new Board member orientation program, and is similar to the unrestricted access that PSERS' Chief Counsel and Chief Investment Officer have to the Board. The Internal Audit Office, in the performance of its duties, also has unrestricted access to all aspects of PSERS' operations.

**Department of the Auditor General's Comments on PSERS' Response**

The Department of the Auditor General is pleased that PSERS is considering our recommendations. Although the Department recognizes the fact that PSERS' Internal Audit Office may have access to both PSERS' Audit/Budget Committee and the full Board, our test work clearly documented that the Internal Auditor reports only to the Executive Director and does not interact with the Audit/Budget Committee with respect

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to internal audits. While an internal auditor can never be completely independent, a structure in which the internal auditor reports to an organization's board audit committee ensures the highest possible level of internal auditor independence. Furthermore, to the extent that PSERS' Internal Audit Office has access to the full Board, our recommendation is for the Internal Audit Office to take advantage of this access by presenting the Audit/Budget Committee with an annual audit plan and copies of audits completed by the Internal Audit Office, and formalizing and adopting a charter.

In its response, PSERS did not address our recommendation to review the staffing level of the Internal Audit Office. Therefore, we reiterate the importance of our recommendation that the Internal Audit Office should be afforded a complement more in line with the duties and mission of the Internal Audit Office.

**IFS' Response**

IFS did not respond to this finding.

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## **Chapter Two      Legal Provisions Governing PSERS' Investment Operations**

Pennsylvania has had a retirement system for public school employees since as early as 1917. Established by Act 343 of 1917, PSERS was governed by a retirement board consisting of seven members who were the trustees of the retirement funds created by the law. Membership on the board at that time included: the “Superintendent of Public Instruction” (as the Secretary of Education was then called), the State Treasurer, one member appointed by the Governor, three members of the “retirement association” (as the retirement system was then called), and one member who was not a public school employee or a state officer or employee.

PSERS is governed by the Public School Employees' Retirement Code,<sup>50</sup> which was enacted by Act 96 of 1975 and which recodified and amended an earlier law governing PSERS adopted in 1959 (Act 77 of 1959). Through the adoption of Act 96 of 1975, the retirement board's membership increased from 8 to 15 members and it became an “independent administrative board.”<sup>51</sup> The Board is responsible for administering the retirement fund and the health insurance fund and has fiduciary responsibility for managing the fund in accordance with the PSERS Retirement Code.

### **Objectives and Methodology**

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

To accomplish this objective, we specifically examined:

- How legal provisions governing PSERS' investment operations impacted its independence<sup>52</sup> and its ability to achieve its mission;

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<sup>50</sup> 24 Pa.C.S. § 8101 *et seq.*

<sup>51</sup> 24 Pa.C.S. § 8501(a).

<sup>52</sup> Please note that our analyses and determination that PSERS is not hampered by its current organizational placement within the executive branch of Commonwealth government and that, in fact, the

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- Whether PSERS' policies and procedures consistently referenced the prudence standard with which PSERS has determined its Board must abide; and
  - Whether the prudence standard in the PSERS Retirement Code, which was adopted in 1975, 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 PSERS Retirement Code;
- Reviewed the provisions of the Commonwealth Attorneys Act<sup>53</sup> and relevant case law;
- Reviewed the provisions of the Administrative Code pertaining to the Commonwealth's budget procedures;<sup>54</sup>
- 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 Retirement Code and PSERS' 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"<sup>55</sup> 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

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pension plan and its members benefit from this organizational placement differs from the conclusion reached by IFS. Please see our responses to IFS' PSERS Report I and II.

<sup>53</sup> 71 P.S. § 732-101 *et seq.*

<sup>54</sup> 71 P.S. § 229 *et seq.*

<sup>55</sup> 20 Pa.C.S. § 7201 *et seq.*

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- Interviewed appropriate PSERS 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 PSERS' operations, including legal, budgetary, and procurement independence, our results and conclusions differed more from IFS here than in any other common objective.

Although the PSERS Board is an "independent administrative board," PSERS 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, PSERS and its Board are also subject to some resulting restrictions. Examples of the restrictions that were pointed out by staff members of PSERS during interviews with us include the fact that the staff sometimes feels constrained by its lack of control over PSERS' budget, the hiring of staff, and staff complement.

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

Despite the fact that the PSERS Retirement Code designates the PSERS Board as an “independent administrative board,” certain provisions of the Retirement Code make it apparent that PSERS 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.”<sup>56</sup> Furthermore, the Retirement Code provides that the PSERS Board “ shall, **through the Governor**, submit to the General Assembly annually a budget covering the administrative expenses of this part.”<sup>57</sup> [Emphasis added.]

None of the provisions of the Retirement Code appear to hamper PSERS and the Board's ability to make investments they deem appropriate or to prevent the fulfillment of PSERS' mission. Moreover, because the restrictions to which PSERS is subject under OA's jurisdiction appear to be entirely administrative in nature, OA's oversight does not appear to hamper PSERS' independence to make investments or its ability to achieve its mission. In fact, PSERS' staff did not provide any examples of how the Retirement Code or OA may have undermined PSERS' ability to make investments, constrained its investment strategy, or prevented it from attaining its mission.<sup>58</sup> The constraints PSERS faces appear to be those customarily encountered in the normal course of the operations

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<sup>56</sup> 24 Pa.C.S. § 8502(a)(2).

<sup>57</sup> See 24 Pa.C.S. § 8502(c). Please note that it appears that this reference to submission of PSERS' budget “through the Governor” was added to make it readily apparent that PSERS' 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), submit 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.

<sup>58</sup> Given that PSERS was recently granted approval for a staff complement increase for the addition of 11 of 14 requested staff positions, which was the first such request submitted in about a decade, concerns about the difficulty PSERS faces in increasing its staffing complement would appear to be alleviated.

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of an agency of government. On the other hand, it is readily apparent that OA provides PSERS 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.

Some of the major advantages and disadvantages of retaining the current structure in which OA provides support to the administrative operations of PSERS 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
PSERS 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.	PSERS 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.
PSERS 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.	PSERS 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.
PSERS 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.	PSERS 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 certain managerial initiatives and decisions.
PSERS and its Board can rely upon OA's	PSERS and its Board are subject to



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Advantages	Disadvantages
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.	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 them having to obtain additional approvals or not gaining approval for certain employee classification, salary, and complement requests.
PSERS and its Board can rely upon OA assistance to help ensure proper employee training and providing access to a wide array of reference materials.	PSERS and its Board may be at times be required to obtain OA approval or have to coordinate with OA for certain training programs they wish to provide their staff members.
PSERS and its Board can rely upon OA as well as the Governor's Office of the Budget for assistance with formulating PSERS' annual budget.	PSERS and its Board are subject to oversight by OA and the Governor's Office of the Budget with regard to PSERS' annual budget, which directly impacts on the size of the budget.
PSERS and its Board can rely upon OA's Office for Information Technology for assistance with their computer and technology issues.	PSERS 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, PSERS 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, PSERS and its Board may be more constrained in the policies, practices, procedures, and new initiatives they adopt than they would be if PSERS were an entirely independent agency. However, given the examples cited by PSERS' staff of how they are impacted by OA's oversight, it appears that these constraints 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 PSERS' staff and Board.

Furthermore, based on the results of a survey that the Department 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

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Table 4 for a summary of the responses to our survey and Appendix A for a detailed presentation of responses.

**Table 4. Summary of Survey of Other States' Pension Systems' Budgetary, Personnel, and Procurement Autonomy.<sup>59</sup>**

Degree of Autonomy	Total Number of Systems Other Than Pennsylvania	Public Employee Pension System	Teacher's/School Employee Pension System
<u>Complete</u> <sup>60</sup>	6	Colorado, Massachusetts, Missouri, Ohio, Texas	Ohio <sup>61</sup>
<u>Limited</u> <sup>62</sup>	11	Arkansas, Florida, Idaho, Mississippi, Nebraska, New Mexico, Oklahoma, Oregon, South Dakota, Wisconsin, Wyoming	<u>N/A</u>
<u>Partial</u> <sup>63</sup>	11	Georgia, Indiana, Iowa, Kansas, Louisiana, Maryland, Nevada <sup>64</sup>	California, Louisiana, Massachusetts, Ohio <sup>65</sup>

<sup>59</sup> 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, which are not included in Table 4. The Department's survey instrument is reproduced in Appendix A.

<sup>60</sup> "Complete" autonomy is generally defined for purposes of this audit report as independence in all three areas (budgetary, personnel, and procurement) examined.

<sup>61</sup> The membership of this pension system, known as the Ohio School Employees' Retirement System, does not include teachers.

<sup>62</sup> "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.

<sup>63</sup> "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.

<sup>64</sup> Georgia – Procurement; Indiana – Personnel; Iowa – Some Procurement; Kansas – Some Personnel; Louisiana – Procurement and Some Personnel; Maryland – Some Procurement; Nevada – Some Personnel.

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**Recommendation**

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

**PSERS' Response**

The Board will consider this finding and the accompanying recommendation. The Board notes, however, that representatives from the Office of Administration (OA) are currently the Board designees for the Secretary of Education and, in that capacity attend most Board meetings. Moreover, various PSERS' staff members are in regular contact with OA on both a formal and informal basis as PSERS seeks to comply, *inter alia*, with both the Commonwealth's personnel standards and the enterprise requirements governing PSERS business continuity plans and information technology infrastructure/operations.

**Department of the Auditor General's Comments on PSERS' Response**

The Department of the Auditor General is pleased that PSERS will consider our recommendation. We note that, regardless of the position in Commonwealth government that designees of the Secretary of Education may hold, they are not representatives of OA when they serve in the capacity as the secretary's duly authorized representative who, pursuant to Section 8501(a) of the Public School Employees' Retirement Code, are called upon to act solely on his behalf.<sup>66</sup> Furthermore, while we would fully expect that PSERS' staff members would be in regular contact with OA on both a "formal and informal basis," we maintain that it would, nonetheless, be beneficial for PSERS to pursue 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.

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<sup>65</sup> California – Some Personnel; Louisiana – Procurement and Some Personnel; Massachusetts – Personnel; Ohio (Ohio State Teachers Retirement System) – Budgetary and Some Personnel.

<sup>66</sup> 24 Pa.C.S. § 8501(a).

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**IFS' Response**

In Chapter Two, DAG states, "Moreover, because the restrictions to which PSERS 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 PSERS’ independence to make investments or its ability to achieve its mission. . . . The constraints PSERS faces appear to be those customarily encountered in the normal course of the operations of an agency of government."

While it may be accurate to describe the constraints PSERS operates under as "administrative," that characterization does not diminish the significance of those constraints. Being subject to outside control over core functions such as personnel, procurement and budgeting has the potential to impact adversely PSERS’ investment operations. As DAG points out, PSERS had not requested an increase in staff complement "in about a decade" (Audit Report, footnote 58). Our interviews indicate that the absence of such requests reflected less a lack of need than a form of self-imposed restraint due to the complexity and difficulty of the process of obtaining outside approvals.

While such constraints may be typical "in the normal course of operations of an agency of government," PSERS is different from typical government agencies. Its expenses are paid from PSERS’ assets rather than general revenues, and the PSERS 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 PSERS 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 PSERS, they had no independent authority over procurement, budgeting and personnel.

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DAG also avers “that OA oversight may provide pension plan members with some additional assurances that there are checks and balances on PSERS’ staff and Board.” In our view, proper checks and balances are provided by a diverse Board, representative of the several stakeholders in the System, which PSERS has, 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 PSERS members, and which is therefore responsive to concerns extraneous to PSERS, to act as a “check and balance” on the System’s fiduciaries.

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**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 differences may be attributable to interpretation and others may be due to differences in the specific survey questions used.<sup>67</sup>

**Department of the Auditor General’s Comments on IFS’ Response**

Pennsylvania’s public school employee’s retirement system has been part of the executive branch of Commonwealth government since 1917. The retirement system has been governed by an “independent administrative board” since PSERS was established by Act 96 of 1975. It is apparent that the General Assembly intended for PSERS to be

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<sup>67</sup> 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 (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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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 PSERS 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 PSERS' current organizational placement has caused actual or tangible constraints on the ability of the PSERS Board to make investments or achieve its mission. However, IFS continues to advocate overturning longstanding precedent by seeking to have PSERS 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 PSERS could cause for PSERS' 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 PSERS 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. 131 of the IFS PSERS Report II) that an arrangement could be made to allow PSERS to continue using the services of, for example, the Governor's Office of Administration and the Governor's 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.<sup>68</sup>

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

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<sup>68</sup> We also note that, despite IFS' statement on page 131 of its PSERS Report II that PSERS currently provides OGC with reimbursement for the legal services it received, we verified with PSERS' staff that PSERS **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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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 PSERS 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 PSERS. 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 PSERS, 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.

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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 PSERS’ Independence To Make Investments Or Its Mission.**

The PSERS Retirement Code provides that the Attorney General is the legal advisor of the Board.<sup>69</sup> 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.<sup>70</sup>

A 1988 decision by the Commonwealth Court of Pennsylvania makes it apparent that PSERS and its Board (as well as 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 PSERS (and SERS) is part of the executive branch of state government.<sup>71</sup> Some of the major advantages and disadvantages of retaining the current structure, in which OGC provides legal support to the operations of PSERS and its Board, are as follows:

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<sup>69</sup> See 24 Pa.C.S. § 8501(e).

<sup>70</sup> 71 P.S. § 732-502 (enacted through Act 164 of 1980),

<sup>71</sup> 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 the 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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Advantages	Disadvantages
PSERS' 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 PSERS legislative	Because PSERS' 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 PSERS 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 PSERS 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 PSERS 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 PSERS and its Board and can attend OGC's Continuing Legal Education courses on a vast array of topics.	No apparent disadvantage.

It is apparent that PSERS and its Board can benefit greatly from the vast resources that OGC as a whole can provide. At the same time, PSERS and its Board may be somewhat constrained by OGC policies and procedures. However, given the examples cited by PSERS' staff members of how they are impacted by OGC legal support, it appears that these constraints solely impact on administrative matters. It must also be

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noted that OGC oversight may provide pension plan members with some additional assurances that there are checks and balances on PSERS' staff and its Board members.

If PSERS determines that it is problematic to have OGC provide it with legal services, PSERS should, with appropriate written justification, seek approval from the General Counsel to grant PSERS' current Chief Counsel and his assistant's independence from OGC. In the alternative, PSERS 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:

- PSERS' 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 PSERS' 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 PSERS determines that it is problematic to have OGC provide it with legal services, PSERS should, with appropriate written

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justification, seek approval from the General Counsel to grant the PSERS' current Chief Counsel and his assistants complete independence from OGC,<sup>72</sup> or PSERS could seek authorization from the General Counsel to hire a chief counsel and various assistants, perhaps through a memorandum of understanding

**PSERS' Response**

The Board will consider this finding and the accompanying recommendations. With respect to the finding, the Board notes that, as with the other findings on independent authority for PSERS, there are valid arguments on both sides of this issue. While there has been no recent history (fifteen plus years) in which counsel may have been needed because of a potential conflict of interest between PSERS and the Governor's Office, that does not preclude a future reoccurrence of the issue. As for the recommendations, PSERS legal staff does work closely with the Office of General Counsel (OGC) and is unaware of any recent history of delays and unnecessary burdens that have occurred as a result of OGC policies and procedures. Moreover, PSERS' Chief Counsel attends a meeting of all Chief Counsels under OGC's jurisdiction on a bi-weekly basis and furnishes weekly or bi-weekly reports to the General Counsel regarding legal activities at PSERS. Further, PSERS' Chief Counsel regularly reports to liaison counsel at OGC, as well as to the General Counsel herself, on issues requiring their attention. Finally, absent legislation, the Board is unaware of any mechanism or process to ensure or obtain a binding, permanent MOU from the Office of General Counsel granting PSERS independent legal counsel.

**Department of the Auditor General's Comments on PSERS' Response**

The Department of the Auditor General is pleased that PSERS will consider our recommendations. We acknowledge that PSERS' legal staff works closely with OGC and that the communication and cooperation between them has generally eliminated any

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<sup>72</sup> PSERS has occasionally availed itself of OGC's current practice of granting PSERS authorization to hire its own separate counsel on a case-by-case basis.

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delays or unnecessary burdens. We also note that, while there is always the potential for the reoccurrence of a possible conflict of interest between PSERS and the Governor's Office, the effects of this conflict have been dealt with through OGC's existing procedure for providing authorization to PSERS to hire its own separate counsel on a case-by-case basis, which has on occasion been utilized by PSERS.

With respect to obtaining an MOU that would grant PSERS legal staff complete independence from OGC, we agree that it would not be possible to obtain a binding, permanent MOU without legislation that would transcend different gubernatorial administrations. However, such an MOU could function as a valid, defensible negotiated agreement within an administration should PSERS determine that there is a need for one.

**IFS' Response**

DAG presents in Table 5 a list of the "Advantages and Disadvantages of the Current Structure that Provides for Legal Support [for PSERS] from OGC." IFS agrees that the items identified as "Advantages" can benefit PSERS, but it is not clear that those advantages, such as the availability of OGC attorneys to consult with PSERS and Continuing Legal Education courses, would not be available if PSERS' attorney was an appointee of, and accountable solely to, PSERS.

**Department of the Auditor General's Comments to IFS's Response**

We reiterate our disagreement with IFS' recommendation that the PSERS 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 PSERS Board, with administrative reporting responsibility to the Executive Director or, until such time as legislation is enacted, that PSERS seek a memorandum of understanding ("MOU") with the General Counsel providing for such authority. Because IFS has indicated that the PSERS' Chief Counsel "provides capable legal support to the investment function"<sup>73</sup> and IFS has not provided any specific examples of instances in which the PSERS' Chief Counsel has had a conflict of interest in serving PSERS and the Board, there does not appear to be any justification for the PSERS Board to go through the time and expense of pursuing a

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<sup>73</sup> IFS PSERS Report I, p. 76.

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change to state law. In addition, it is not clear why an MOU is necessary because OGC already provides authorization for PSERS to hire its own separate counsel on a case-by-case basis, which PSERS has exercised on occasion.

Furthermore, we disagree with IFS that an independent counsel appointed by and solely accountable to PSERS 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 PSERS' independent counsel.<sup>74</sup>

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<sup>74</sup> It must be noted that PSERS would require statutory or General Counsel authority to hire an independent counsel.

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**Finding 2.3 - PSERS 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.<sup>75</sup> 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; and
- (6) deter the fiduciary from acquiring new types of investment products.<sup>76</sup>

In 1999, the Pennsylvania General Assembly amended the Probate, Estates and Fiduciaries Code<sup>77</sup> (Probate Code) by adopting the “Prudent Investor Rule”<sup>78</sup> 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

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<sup>75</sup> 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 (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.”

<sup>76</sup> Horn, *ibid.*, p. 5.

<sup>77</sup> 20 Pa.C.S. § 101 *et seq.*

<sup>78</sup> 20 Pa.C.S. 7201 *et seq.*

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individually be judged to be prudent or imprudent” to one in which “the total portfolio ...is reviewed and not any investment in isolation.”<sup>79</sup> 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;

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<sup>79</sup> 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.<sup>80</sup>

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.”<sup>81</sup>

**Fiduciary Duties and Prudence Standard of the PSERS Board Members**

Section 8521(e) of the PSERS Retirement Code states, states the following, in pertinent part, with regard to the fiduciary duties of the PSERS 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.<sup>82</sup>

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<sup>80</sup> 20 Pa.C.S. § 7203.

<sup>81</sup> 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).

<sup>82</sup> 24 Pa.C.S. § 8521(e).



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Therefore, PSERS Board members stand in a fiduciary relationship with the plan's 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 PSERS 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 PSERS Board members are subject, Section 8521(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.<sup>83</sup>

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

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<sup>83</sup> 24 Pa.C.S. § 8521(a).

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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.” [Emphasis added.] In contrast to the SERS Board, members who are trustees of only that plan’s fund, the Board members of PSERS are also trustees of the Public School Retirees’ Health Insurance Fund pursuant to Section 8903 of the PSERS Retirement Code, and are subject to the identical prudence standard with respect to that fund.<sup>84</sup>

We learned during the course of this audit that PSERS 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 PSERS 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”
Securities Litigation Policy	“Prudent Investor”
Travel and Education Policy	“Prudent Investor”
The Mission Statement in the System’s 2005/2006 Budget Report	Prudent Investor (implied by discussion of “prudently investing” funds)

In September 2005, the Department inquired with PSERS’ Office of Chief Counsel about the terminology that office believed was appropriate to describe the prudence standard to which PSERS has determined its Board is subject. As a result of this inquiry, PSERS’ Office of Chief Counsel initiated a review of this issue in consultation with its SERS 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

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<sup>84</sup> 24 Pa.C.S. § 8903.

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PSERS 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 what was said during the telephone conversation, both Systems’ chief counsels stated as follows, in pertinent part:

[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.”<sup>85</sup>

With regard to whether the 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.”<sup>86</sup>

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<sup>85</sup> January 4, 2006 memorandum from SERS’ Chief Counsel and PSERS’ Chief Counsel, to Deputy Chief Counsel, Department of the Auditor General, p. 1.

<sup>86</sup> *Ibid.*, p. 2. It is unclear on what basis the plans’ chief counsels concluded 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 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

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The fact that PSERS 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 PSERS Board members are subject raises significant concerns about whether their Board members have been adequately prepared to fulfill the prudence standard.<sup>87</sup> While IFS has indicated that it agrees with the Systems that they are subject to the “prudent investor” standard<sup>88</sup>, 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. In addition, IFS pointed out in the letter that “it was advisable for trustees to obtain the training necessary for them to meet their challenging fiduciary responsibilities.”<sup>89</sup>

### **Recommendations**

We recommend that:

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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.

<sup>87</sup> We defer to the opinions of 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.

<sup>88</sup> See IFS’ Report I, Section I-C, “Legal Matters,” p. 80.

<sup>89</sup> 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 conference 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 IFS believes that such a determination exceeds the scope of IFS’ review.

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- PSERS should ensure that all of its documents consistently refer to the “prudent investor” standard, which is the prudence standard to which PSERS’ Chief Counsel has determined the PSERS Board members are subject.
- All PSERS 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 PSERS members if they do not meet their obligations.

**PSERS’ Response**

The Board will consider this finding and the accompanying recommendations. In doing so, the Board notes that regardless of the technical legal terminology applied to PSERS’ prudence standard, the Board is not unsure of, but is well aware of and adheres to the fiduciary standards set forth in Section 8521 of the PSERC [Pennsylvania Public School Employees Retirement Code], including the duty of loyalty (exclusive benefit rule) and prudence. This adherence to its fiduciary responsibility applies not only when the Board oversees the investment of PSERS’ assets, but also in managing benefits and all other aspects of PSERS’ extensive operations. Thus the Board does not share the Auditor General’s same “significant concern”, that the Board may be unprepared to fulfill its duty of prudence because certain PSERS’ documents used different terms to describe the fiduciary standard applicable to PSERS. On the contrary, at all times PSERS’ Board members have been and continue to be adequately prepared to fulfill the prudence standard set forth in Section 8521 of the PSERC. Notwithstanding, PSERS has already taken steps to identify the Prudent Investor Rule as the applicable fiduciary standard in its various policy documents. See e.g. PSERS’ response to IFS Recommendation IIA-1.

**Department of the Auditor General’s Comments on PSERS’ Response**

The Department of the Auditor General is pleased that PSERS has already taken steps to implement our first recommendation by ensuring that its various policy

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documents utilize the same terminology to identify the prudence standard to which PSERS' Chief Counsel has determined the Board is subject. As discussed in our finding, 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.<sup>90</sup>

With regard to our other recommendation, we acknowledge that PSERS' Board would have always known that the prudence standard to which the Board is subject when making investments is set forth in Section 8521(a) of the Public School Employees' Retirement Code.<sup>91</sup> However, knowing where to find language in a governing statute does not equate with the articulation of what the standard actually means both in terms of the Board member obligations that arise and the Board members' ability to fully comprehend what consequences arise if they do not meet their obligations. Based on PSERS' response, it appears that PSERS' Board members have been and continue to be instructed on their fiduciary obligations.

**IFS' Response**

IFS concurs with DAG's recommendation in its Finding 2.3 that it would be appropriate for PSERS 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.

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<sup>90</sup> For example, as referenced in our report, 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.

<sup>91</sup> 24 Pa.C.S. § 8521(a).

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**Finding 2.4 – It Is Unclear Whether The Prudence Language In The PSERS 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."<sup>92</sup> 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 the PSERS' 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 PSERS Retirement Code as adopted in 1974 contains all of the necessary elements to encompass modern portfolio theory and investment diversification principles<sup>93</sup> as those contained in the "Prudent Investor Rule" adopted for estate trustees in 1999.

**Recommendations**

Because PSERS and the PSERS 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 PSERS Retirement Code containing the Board members' prudence

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<sup>92</sup> Miller, Bookman, and Duronio, *ibid.*, p. 1.

<sup>93</sup> Miller, Bookman, and Duronio, *ibid.*, p. 2.

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standard to ensure that it encompasses all of the key elements of the Prudent Investor Rule contained in the Pennsylvania Probate Code. Alternatively, or in the meantime, PSERS should amend its investment policy accordingly.

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

**PSERS' Response**

The Board agrees with the Auditor General that this is ultimately a matter for the General Assembly since it requires legislative action. Notwithstanding, the Board is in favor of legislatively clarifying or enhancing the PSERC's current statement of the Prudent Investor Rule to comply with the more recent legislative rendition of the Rule expressed in the Probate Code. In the interim, PSERS has already taken steps to amend its Investment Policy Statement to consistently reflect the Prudent Investor Rule, including the modern portfolio theory, as the applicable prudence standard governing PSERS' investment operations. See PSERS' response to IFS Recommendation IIA-1.

**Department of the Auditor General's Comments on PSERS' Response**

The Department of the Auditor General is pleased that PSERS agrees with our determination that there is a need to seek legislative clarification and enhancement of the prudence standard contained in the Public School Employees' Retirement Code to reflect the language of the "Prudent Investor Rule" contained in the Probate, Estates and Fiduciaries Code and that it has, in the interim, taken steps to amend its Investment Policy Statement accordingly.

**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 study to diversify the System's investments. In its recommendations following 2.4, DAG



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recommends legislation “amending the PSERS 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 provide 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. . . .”<sup>94</sup>

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 in 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.”

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<sup>94</sup> IFS Footnote: 20 Pa.C.S. § 7201.

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**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 PSERS Retirement Code's formulation of the prudence standard could be improved upon by, for example, making specific reference to a duty to diversify PSERS' investments.<sup>95</sup> We note that our recommendation that legislation be sought to amend the PSERS Retirement Code to reflect the Prudent Investor Rule contained in the Probate 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 PSERS because it has a proven track record having been adopted by the vast majority of states, including Pennsylvania through Act 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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<sup>95</sup> IFS also acknowledges this lack of a diversification requirement in its discussion of the PSERS Board's prudence standard in IFS' PSERS Report I.

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## **Chapter Three Investment Advisory Consultants**

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

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

Section 8502(j) of the Retirement Code requires the PSERS Board to hire an actuary.<sup>96</sup> Within six months of the end of each calendar year, the actuary performs an annual valuation, which PSERS 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 PSERS 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 PSERS' 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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<sup>96</sup> 24 Pa.C.S. § 8502(j).

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To accomplish this objective, we examined the following:

- If PSERS awarded investment advisory consultants' contracts in accordance with Pennsylvania laws and regulations;
- If the investment advisory consultants and actuary complied with their contracts; and
- If any conflicts of interest were present that could interfere with the investment advisory consultants' ability to provide the best advice to PSERS.

Accordingly, we completed the following audit steps:

- Reviewed Pennsylvania laws and regulations that pertain to the selection of PSERS' investment advisory consultants and actuaries;
- Examined the four Requests for Proposals (RFP) for investment advisory consultants that PSERS issued during the audit period;
- Reviewed the selection committee's due diligence rating process used to review and rank the 16 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 contract for each of the three investment advisory consultants and the actuary PSERS employed during the audit period;
- Examined PSERS' policies and procedures in place to identify any potential conflicts of interest between investment advisory consultants and investment managers;
- Examined reports generated by the investment advisory consultants and actuary;

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- Reviewed the meeting minutes from 45 Board meetings and attended 10 Board meetings to observe the investment advisory 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 the investment advisory consultants in general, the specific services required by PSERS' consultant contracts, and the services actually provided by each PSERS consultant. We tested and reported on PSERS' processes for awarding the consultants' contracts and for monitoring contract compliance. Both reports describe efforts to review compliance with SEC regulations concerning consultant conflict of interest. We also conducted testing 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 that context.

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**Finding 3.1 – PSERS' Procurement Process For The Selection Of Investment Advisory Consultants And The Actuarial Services Worked As Intended.**

PSERS 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's Procurement Code.<sup>97</sup>

In addition to following the RFP Process, PSERS 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, PSERS identified potential consultants who were then interviewed by the selection committee. Following the interviews, the selection committee ranked the candidates. The fee proposals submitted by the candidates were then opened and ranked based on the price, cost, and other factors such as meeting Commonwealth equal opportunity standards. After the scores were compiled, the consultant with the highest cumulative score was awarded the individual consulting contract.

Audit testing of PSERS' investment advisory and actuarial consulting contract award process found that the committee adequately reviewed the information that was presented to it and rated each firm based on this information.

**Recommendation**

No recommendation is necessary.

**PSERS' Response**

The Board is very pleased that the Auditor General concluded that PSERS' procurement of investment advisory consultants and actuarial services complied with the applicable procurement rules and that the vendors are performing in accordance with their respective contracts with PSERS.

**IFS' Response**

IFS did not respond to this finding.

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<sup>97</sup> 62 Pa. C.S. §518(c).

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**Finding 3.2 – PSERS' Investment Advisory Consultants And Actuary Complied With Their Contractual Obligations.**

Our review found that PSERS' investment advisory consultants and actuary complied with their respective contracts. Specifically, we verified that the consultants attended Board meetings, assisted PSERS' investment staff in completing investment manager searches, participated in the development of PSERS' annual plans, and responded to information requests from the PSERS' staff. All three consultants also provided PSERS with their forms showing that they were registered with the SEC.

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

**Recommendation**

No recommendation is necessary.

**PSERS' Response**

See PSERS' response to Finding 3.1.

**IFS' Response**

IFS did not respond to this finding.

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**Finding 3.3 – PSERS Staff Did Not Disclose Relationships Between PSERS' General Investment Advisory Consultant And External Financial Managers To The Board.**

Business relationships between PSERS' general investment advisory consultant and the investment managers the consultant recommends to the Board can give rise to serious potential conflicts of interest, yet we found that these relationships were not disclosed to the Board. Specifically, our review revealed that, during 2004 and 2005, PSERS' general investment advisory consultant earned more than \$5.8 million in fees from investment managers hired by PSERS. However, while not disclosed to the Board, we did note that PSERS' staff had implemented procedures to monitor these relationships.

The SEC has recognized that the investment industry is filled with potential conflicts of interest. For example, the SEC has indicated that pension consultant firms commonly provide services to a dual customer base. The SEC found that many investment advisory consultants who provide advice to pension plans also had business relationships with the investment managers they recommend to their pension plan clients. The SEC addresses this concern in a report released in 2005, which states in part:

Questions have been raised regarding the independence of the advice that pension consultants provide in light of the fact that many pension consulting firms provide services both to pension plans who are their advisory clients *and* to [investment] managers. This duality in many pension consultants' customer base may create a conflict of interest, which has the potential to cloud the objectivity of a pension consultant's recommendations to advisory clients. Concerns exist that pension consultants may steer clients to hire certain [investment] managers and other vendors based on the pension consultant's (or an affiliate's) other business relationships and receipt of fees from these firms, rather than because the [investment] manager is best suited to the clients' needs. Such a conflict of interest can compromise the fiduciary duty that investment advisers owe their clients.<sup>98</sup>

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<sup>98</sup> *Staff Report Concerning Examination of Select Pension Consultants*, Office of Compliance Inspections and Examinations, U.S. Securities and Exchange Commission, May 16, 2005, p. 3.



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Because the services provided by PSERS' general investment advisory consultant consisted of assistance with the investment plans, allocating assets, selecting investment managers, and tracking investment performance, any relationships between the consultant and the investment managers it recommends to the Board should be disclosed to the Board. PSERS' staff informed us that they ensured that the general investment advisory consultant implemented internal controls to mitigate the potential for conflicts of interest between the consulting and financial services divisions of its company.

Although the relationship between the consultants and the investment managers was not disclosed to the Board, PSERS' Investment Office's Risk and Compliance Division monitored these relationships by requiring PSERS' 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, and a list of their other business activities.<sup>99</sup> We conducted testing and verified that each of the consultants submitted the annual report and PSERS' staff reviewed it. In addition, beginning in 2004, PSERS added a provision to all new investment manager contracts requiring the disclosure of any business relationships the investment managers had with PSERS' general investment advisory consultant. For existing contracts, PSERS requested the information from the managers via an e-mail and the managers complied with this request. PSERS' staff informed us that they will do a cross-check of the information provided by the consultant and the managers.

While we acknowledge that the staff monitors potential conflicts of interest involving the investment advisory consultant and investment managers, it is the Board that has the final decision making authority on potential investment managers. Therefore, all pertinent information, including potential conflicts of interest, should be disclosed to the Board to help ensure that a prudent decision is made.

**Recommendations**

We recommend that PSERS' staff continue to require investment managers to report any relationships they have with PSERS' investment consultants. Additionally,

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<sup>99</sup> All registered investment consultants must complete the SEC's Form ADV. Any client can obtain copies of this form from the SEC. Among other things, Form ADV asks consultants to state their affiliations, participation or interest in client transactions, brokerage transactions, and compensation received from client referrals.

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information regarding any potential conflicts of interest and business relationships between the investment managers and the general investment advisory consultant should be disclosed to the PSERS Board prior to its voting on an investment manager.

**PSERS' Response**

PSERS agrees with the finding and recommendation. Going forward, PSERS will require that this information be disclosed to the Board for each new manager recommended by staff and by all investment consultants used by PSERS. In doing so, however, the Board notes that it has been extensively briefed on the underlying issue of the potential for a conflict between its general investment consultant and external investment managers who purchase services from other divisions of PSERS' general investment consultant. The Board also notes that PSERS' general investment consultant maintains firewalls between its consulting division and other divisions to insure that the investment consultants are in no way biased in their recommendations. Access to this information has been provided to PSERS' staff through [the general investment consultant's] accounting division and is routinely monitored by staff.

**Department of the Auditor General's Comments on PSERS' Response**

The Department of the Auditor General is pleased that PSERS agrees with our finding and recommendation. The Department acknowledges PSERS' effort to educate and inform Board members on the issue of the potential for a conflict between its general investment consultant and external investment managers. We again reiterate our recommendation that Board members should be made aware of these potential conflicts before a decision to hire a new manager or renew an existing contract is voted upon.

**IFS' Response**

While the staff may not have disclosed the details of the relationships between [the general investment consultant] and individual external financial managers, in our Report we note that in May 2005, staff did inform the Board of the potential conflicts of interest that exist and presented the Board with a summary of the issues raised in the SEC report and an analysis of the extent to which the practices of [the general

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investment consultant] created conflicts for the Fund. In particular staff noted that [the general investment consultant] sells software and analytical programs to investment managers and that the consultant maintained a broker-dealer business relationship until 2004. See our PSERS Report I Task Area I-D Investment Consultants' for further detail.

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

The Department of the Auditor General disagrees with IFS that the May 2005 staff efforts to inform the Board of the potential conflicts of interest between the general investment consultant and external investment managers were adequate to address this issue. We assert that the discussion regarding consultant's conflicts-of-interest should be an ongoing discussion rather than a one-time event in response to an SEC report. Our review of all January 1, 2001, to March 31, 2005 Board meeting minutes as well as attendance at all April 1, 2005, to June 30, 2006 Board meetings disclosed that the May 2005 consultant conflict-of-interest discussion was the only one held by the PSERS Board. Additionally, we assert that these discussions should involve the discussion of specific conflicts with current and potential future PSERS' investment managers rather than a discussion of consultant conflict-of-interest issues in general.

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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 funds such as PSERS 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 firm's performance;
- Analysis of the firm's performance in comparison to a peer group;
- Review of the firm's audited financial statements;
- Review of press reports and SEC filings; and
- Identification of any regulatory and/or licensing issues.<sup>100</sup>

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. Thorough due diligence investigations are essential for a pension plan 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 investment

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<sup>100</sup> "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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commitment. A pension plan will either use in-house resources or an outside investment advisory consulting firm, or both, to conduct the due diligence investigation.

PSERS' Board relies heavily on both the staff and consultants to make recommendations on appropriate investment managers to hire. After completing the due diligence process, the staff, in conjunction with the consultant, selected the investment manager to be recommended to the Board for approval. The Board is provided with the full due diligence report for the manager recommended by staff and the consultant. Additionally, the investment manager sometimes makes a presentation to the PSERS Board. We noted that, during the audit period, the Board approved *all* of the investment managers recommended by the staff and the consultant.

Upon approval of an investment manager, a pension plan should initiate a monitoring process. This monitoring process should ensure that the investment manager met contract requirements and had satisfactory performance. Typically, the process should include:

- Review of the investments in the portfolio to ensure compliance with the parameters set forth in both the pension fund's investment policy statement and in the investment management firm's contract;
- Calculation of the fair market and book value of the investments in the portfolio;
- Calculation of the investment income and/or investment return; and
- Review of all fees received by the investment management firm.<sup>101</sup>

In addition to the above review, pension fund staff typically performs on-site visits of the investment managers. The purposes of the visits are to observe any significant changes in the managers' corporate or capital structure, investment strategy, and changes in professional or investment staff.

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<sup>101</sup> Albert, Rory Judd, "Selecting and Monitoring Investment Professionals," *Benefits & Compensation Digest*, Vol. 42, No. 6, June 2005, pp. 6-7.

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**Objectives and Methodology**

Our objective was to determine if PSERS' 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 PSERS' policies and procedures pertaining to due diligence and investment manager contract monitoring and invoice processing;
- Randomly selected and reviewed 35 investment managers from PSERS' 2001 to 2004 budget reports to the General Assembly. The sample included managers from all investment classes;<sup>102</sup>
- Reviewed due diligence documents, including both the consultant and staff due diligence reports, for the 22 investment managers in our sample who were hired between 1998 and 2004;
- Reviewed copies of contractually required documents, such as proof of insurance, for 12 investment managers in our sample to determine compliance with contract provisions;
- Reviewed available reports to verify that investment manager compliance monitoring was being completed;
- Reviewed PSERS' investment manager invoice payment process to verify that PSERS had implemented sufficient management controls to ensure that vendor charges were properly reviewed and approved prior to payment;

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<sup>102</sup> PSERS' investment classes were Domestic Equity, International Equity, Fixed Income, Global Asset Allocation (2001 only), Alternative Investments (Real Estate, Private Equity, Venture Capital, and Private Debt (2002-04)).

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- Selected a sample of 12 investment managers and reviewed at least two quarterly invoices for each manager to ensure that management controls were working as intended; and
  - Interviewed Board members, Investment Office staff, including the Risk and Compliance Division staff.

The IFS fiduciary review of this task area is contained in Section III, I-B of Appendix B. IFS reviewed and commented upon PSERS' due diligence and monitoring policies and procedures for investment guidelines. Like IFS, we reviewed PSERS' due diligence and monitoring policies and procedures. However, we also tested and reported on PSERS' compliance with these policies and procedures, as well as tested and reported on PSERS' payment of investment manager 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 – While PSERS' Due Diligence Process For Selecting Investment Managers Appears Adequate, PSERS Did Not Have Formal Policies And Procedures.**

PSERS did not have formal policies and procedures regarding the type and amount of due diligence required to be performed on each investment manager prior to making a recommendation to the Finance Committee and the Board. Without such policies and procedures, PSERS cannot ensure consistency in its due diligence process.

Of the 22 managers in our sample, PSERS provided us with both consultant and staff due diligence reports for 13, only the consultant report for 4, and only the staff report for 5 investment managers hired. These reports included background investigations of the investment management firm's principals, as well as analysis and verification of the performance of previous investments made by the principals. While our review of these reports found that the consultant and staff performed an adequate due diligence investigation and analysis, formal written procedures would provide consistency in the process and clarify when there is a need for both a consultant and a staff due diligence report.

**Recommendation**

We recommend that PSERS develop formal due diligence policies and procedures. At a minimum, these written policies and procedures should include all requirements and steps in the due diligence process to ensure that the due diligence performed allows PSERS' Board members to make, and support, informed decisions and fulfill their fiduciary duties.

**PSERS' Response**

PSERS agrees with the finding and recommendation, particularly the Auditor General's conclusion that PSERS' due diligence process for selecting investment managers is satisfactory. PSERS also notes that it has had policies and procedures in place for selecting investment managers and made a presentation to the Board's Finance Committee on those policies and procedures on March 14, 2002. PSERS agrees, however, that those policies should be formally approved by the Board and thus has added them to PSERS' Investment Policy Statement,



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Objectives and Guidelines, which was approved by the Board on August 4, 2006. See PSERS' response to IFS Recommendation IIA-9.

**IFS' Response**

We agree that PSERS should improve its documentation of its manager search and selection process (i.e., its due diligence procedures). In IFS' PSERS Report I, we state our belief that PSERS' due diligence procedures are thorough and complete; however, we recommend in IFS' PSERS Report II – Additional Objectives not covered by the Pennsylvania Department of the Auditor General that the Investment Policy Statement should include a more detailed description of the manager search process or that it should reference a separate manager search policy document. Procedures can be essentially “complete” even though they are not documented. In addition, we note that IFS was not tasked with testing the application of the procedures.

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

The Department of the Auditor General does not agree with IFS' statement that “procedures can be essentially ‘complete’ even though they are not documented.” For procedures to be complete, there must exist a common understanding of what is required so that even new personnel, with a minimum of instruction, can uniformly and consistently apply the procedures. Only formal written procedures can fulfill these criteria.

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**Finding 4.2 – PSERS Did Not Adequately Monitor Its Investment Managers' Compliance With Their Contracts.**

For the fiscal year ended June 30, 2005, PSERS' external public market investment managers and internal portfolio managers were responsible for 78 percent of PSERS' total investment portfolio, or approximately \$41.3 billion.<sup>103</sup> To address the risks inherent in the management of such a large sum of money, PSERS established the Risk and Compliance Division within the Investment Office, whose primary responsibility was to monitor these firms. To fulfill its monitoring responsibilities, the Risk and Compliance Division is responsible for the following:

- Comparing the performance of both external public market investment managers and internal portfolio managers to an established benchmark and a peer group to ensure that the managers are achieving their contractually required performance standards;
- Completing on-site reviews of external investment managers to observe any significant changes in the investment managers' corporate or capital structure, investment strategy, and changes in professional or investment staff;
- Reviewing quarterly compliance monitoring reports received from investment managers to verify manager compliance with their contracts;
- Reviewing managers' investment holdings to verify the managers' compliance with their contracts; and
- Maintaining copies of the current errors and omission (E&O) and fidelity bond insurance policies required by the investment managers' contracts.

While PSERS' monitoring of the managers' financial performance was adequate, our testing found that PSERS' monitoring of managers' compliance with contract guidelines, objectives, and documentation requirements was deficient. Specifically, because of an underutilization of available monitoring tools, inadequate policies and

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<sup>103</sup> 2005 CAFR, p. 33, calculated by adding fixed income and common and preferred stock totals.

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procedures, and insufficient staffing levels, the Risk and Compliance Division did not adequately fulfill all of its responsibilities.

**Financial Performance Monitoring**

PSERS has an adequate process in place to monitor the investment performance of its external and internal managers. With the assistance of its consultants, PSERS' staff conducts reviews of monthly and quarterly data and reports quarterly performance results to the Board. This review includes, but is not limited, to the following: every quarter the Risk and Compliance Division staff compares the performance of each public market investment manager and internal portfolio manager to an established benchmark and annually compares the managers to the performance of a peer group. PSERS' *Guidelines for Management of Underperforming Managers* contained extensive and well-documented policies and procedures for those managers who are placed on probation as a result of these reviews.<sup>104</sup> Furthermore, our testwork disclosed that these policies and procedures operated as intended.

**Contract Compliance Monitoring**

Beginning in July 2004, the Investment Office's Risk and Compliance Division assumed the responsibility for conducting annual on-site reviews of external public market investment managers and semi-annual reviews of internal portfolio managers. We found that only one on-site review was completed from July 2004 through December 2004. Subsequent to the completion of fieldwork, PSERS provided us with documentation showing that, from January 2005 through March 2006, staff completed an additional 35 on-site reviews of external investment managers. Although this was a significant improvement, these 35 reviews still fall short of the approximately 62 that should have been performed during this period.

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<sup>104</sup> Managers who did not meet performance benchmarks and/or who did not compare favorably to their peer group were placed on probation. These managers were required to report on their performance monthly until either their performance improved and they were taken off probation, or their performance did not improve and they were terminated. For our review, we chose one quarter from each audit year and requested documentation of phone calls and reports for all managers on probation during that quarter. We found that PSERS' staff placed all necessary phone calls and managers submitted all required reports.

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Because staff did not complete all annual on-site reviews of external managers, the Risk and Compliance Division relied on quarterly compliance reports completed by the managers. Each quarterly report is a statement completed by the investment manager verifying compliance with the terms of its contract. Our testing of ten public market managers found that PSERS received all quarterly compliance reports without exception. However, because these reports are essentially a form of self-monitoring, we question the sufficiency of the report.

PSERS' custodian bank provides a software package called *Investment Monitor* that enables PSERS to verify that public market managers' investment holdings comply with their contracts. For our test work, we obtained documentation of all *Investment Monitor* reviews performed on the ten public market investment managers in our sample. During the four-year audit period, only eleven such reviews were completed. In one case that we sampled, no reviews were completed. Because it is possible, and desirable, to review each manager monthly, these eleven reviews were not an effective use of *Investment Monitor*. Staff informed us that the *Investment Monitor* software had not been programmed with the rules specific to the managers' contracts. Therefore, the software program could not be fully utilized. Use of *Investment Monitor* could lessen the reliance that PSERS placed on the investment managers completing self-monitoring quarterly reports. Additionally, a greater use of *Investment Monitor* would improve the staff's efficiency and allow more time for on-site reviews and other compliance monitoring tasks.

During an interview, PSERS' Director of Risk and Compliance acknowledged a lack of sufficient policies and procedures for investment manager compliance monitoring. This lack of written policies and procedures contributed significantly to the monitoring deficiencies identified during our audit. Written policies prevent misunderstandings and contribute to accurate and timely records and reports. Written procedures should provide staff with clear, concise instructions and expectations, reduce errors, eliminate duplicate work, and serve as an aid in training new employees. Written procedures would also provide greater assurance that employees handle transactions consistently, monitor activities effectively, and produce reports that meet management's needs.

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We also noted that the Risk and Compliance Division appears to be understaffed. This understaffing also contributed significantly to the monitoring deficiencies identified during our audit.<sup>105</sup>

**Contract Documentation Monitoring**

Another responsibility of the Risk and Compliance Division is ensuring that investment managers maintain current E&O and fidelity bond insurance policies. Eleven of the managers selected for testing were public market managers and one was a private market manager whose contracts required current policies.

Of these 12 contracts, PSERS did not have fidelity bond policies for one manager in two of the four years. Additionally, for another manager, PSERS did not have either E&O or fidelity bond policies for any of the four years.

Not having current E&O and fidelity bond insurance policies places PSERS at risk should an investment manager make investment decisions that subsequently results in legal action by a third party. These exceptions occurred because staff either failed to obtain documentation or did not properly file documentation.

**Recommendations**

PSERS' Investment Office's Risk and Compliance Division should improve its monitoring of investment managers' compliance with contract guidelines and documentation requirements by:

- Revising and formalizing, in writing, all existing policies and procedures pertaining to all aspects of investment manager performance and compliance. At a minimum, these written policies and procedures should include:
  - Specific steps for each process (e.g. on-site visits, *Investment Monitor* reports, quarterly compliance reporting, underperforming firms, and internal account

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<sup>105</sup> Subsequent to the close of fieldwork, PSERS' Risk and Compliance Division hired an additional employee.

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reviews) employed in monitoring investment management firms and internal portfolio managers;

- Steps for obtaining and retaining contractually required documents; and
- Date the policy was adopted by the Board and, if applicable, the date of any amendments.
- Fully programming *Investment Monitor* and utilizing the software to its fullest capacity; and
- Obtaining and retaining copies of all contractually required documentation, including but not limited to current errors and omission insurance and fidelity bond insurance.

**PSERS' Response**

The Board does agree with the Auditor General's recommendations to improve PSERS' current contract compliance efforts, including the need to have all the existing policies, practices and procedures used by PSERS to monitor all aspects of investment manager performance and compliance documented in writing. To that end, PSERS has hired an additional employee in the Risk and Compliance Division effective July 2006 and will be seeking to add another employee to the Division, subject to approval by the Governor's Budget Office, effective July 2007. The Board believes that this should address the Auditor General's observation "that the Risk and Compliance Division appears to be understaffed. This understaffing also contributed significantly to the monitoring deficiencies identified during our audit." In fact, the Board believes that the understaffing of the Division is the primary cause of the deficiencies noted by the Auditor General.

The Board disagrees, however, with the Auditor General's finding to the extent it implies that PSERS was or is not now properly monitoring the contract compliance of its investment managers because its policies and procedures to do so were not formalized in writing. On the contrary, PSERS does have extensive contract compliance policies, practices and

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procedures, which it follows, notwithstanding that not all of them have been formally documented.

**Department of the Auditor General's Comments on PSERS' Response**

The Department of the Auditor General is pleased that PSERS agrees with our recommendations to improve PSERS' current contract compliance efforts and that PSERS is taking affirmative steps to address their understaffing. We note, however, that contrary to PSERS' assertion that "contract compliance policies, practices and procedures" can exist without being formally documented, such policies, practices and procedures by their very nature require that they be in writing.

**IFS' Response**

We agree that PSERS should improve the documentation of its monitoring procedures. However, while we believe that the staff's stated goals for monitoring guideline compliance would be adequate if consistently applied, this area has been under-resourced (see the discussion in our Report). PSERS has unable to monitor guideline compliance systematically or perform ongoing manager due diligence on-site visits and we recommend the addition of staff to accomplish these goals. On-site visits assist staff in performing a more qualitative review of investment managers, but do not take the place of monitoring compliance with guidelines and their absence is not the reason that staff has had to rely on managers' quarterly certifications. In addition, while we agree that monthly guideline compliance checks would be optimal, quarterly compliance reviews are generally viewed as being sufficient (with the manager being obligated to report exceptions within a short time frame). We note in our Report that PSERS has not made the best use of Investment Monitor, the custodian bank's compliance monitoring program, and concur with DAG's recommendation, to the extent it is feasible given the strategies employed by the various managers.

In our Report, we also recommend that PSERS enhance its monitoring procedures to meet the specific challenges created by the use of new global macro strategies. On this strategy and others, we

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recommend that the Board receive additional information on the risks the external managers incur.

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

We are pleased that IFS agrees with us regarding PSERS' underutilization of the Investment Monitor program, inadequate documentation of monitoring procedures, and the need to increase on-site monitoring of managers. Additionally, for the performance monitoring testing included in our report, our results and IFS' results were the same.



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**Finding 4.3 – PSERS Reviewed And Approved Investment Manager Invoices Correctly.**

During the four-year audit period, PSERS' Investment Accounting Division reviewed and approved investment manager invoices totaling more than \$646.7 million. As outlined in PSERS' "Procedures for Processing Investment Manager Fees," PSERS' Investment Accounting Division invoice review and approval activities include:

- Verifying invoice fee percentages to the fee percentages stated in the manager's contract;
- Reconciling differences between amounts invoiced and amounts calculated by Investment Accounting staff; and
- Preparing documentation, including obtaining authorized signatures, for payment of invoice.

The objective of our testing was to verify that the Investment Accounting Division has adequate policies and procedures, processes investment manager invoices in accordance with these policies and procedures, and pays fees in compliance with each manager's contract. To complete our objective, we:

- Reviewed all procedures that applied to the review and approval of investment manager invoices;
- Interviewed the manager of the Investment Accounting Division;
- Reviewed and recalculated 48 invoices for investment managers included in our sample; and
- Reviewed documentation for payment of the invoices.

We found that PSERS has adequate policies and procedures for payment of investment manager fees and that these policies and procedures were followed. For the 48 invoices that we reviewed and recalculated, all amounts invoiced were in accordance with each manager's contract. Finally, we noted that staff completed the documentation for payment appropriately.

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**Recommendation**

No recommendation is necessary.

**PSERS' Response**

The Board is very pleased that the Auditor General concluded that PSERS' Investment Accounting Division correctly and accurately reviewed and approved 48 invoices involving more than \$646.7 million in investment manager fees.

**Department of the Auditor General's Comments on PSERS' Response**

The Department of the Auditor General was pleased to find and report that PSERS is properly reviewing and approving investment manager invoices. However, the \$646.7 million noted in PSERS response is the total amount of investment manager fees paid by PSERS during the four-year audit period. The amount of fees paid on the invoices tested by the auditors was only \$2.16 million. It was this significantly smaller amount – not the total \$646.7 million – that we verified were correctly and accurately reviewed and approved.

**IFS' Response**

IFS did not respond to this finding.

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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, has started an age of closer scrutiny, more securities regulatory investigations, and, ultimately, more securities litigation.

According to a recent 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 2003 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.<sup>106</sup>

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 litigation, 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 litigation claims against companies involved in accounting scandals and financial frauds.<sup>107</sup>

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.<sup>108</sup> 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 class action strategy is currently driven largely by institutional shareholder plaintiffs. This study noted, "Over 75% of the current

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<sup>106</sup> "2004 PricewaterhouseCoopers LLP Securities Litigation Study," p. 1.

<sup>107</sup> Ibid, p. 7.

<sup>108</sup> Ibid, p.10.

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class actions are headed up by institutional plaintiffs, who are much more active in settlement discussions and aggressive in seeking individual [payments].”<sup>109</sup> The study also affirmed that the future would see an increase in individual securities litigation brought by large shareholders seeking a much greater recovery than that typically afforded in class actions.<sup>110</sup>

### **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 accomplish this objective, we sought to determine:

- If PSERS 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 claims; and
- The amount of securities litigation monies PSERS recovered.

Accordingly, we completed the following audit procedures:

- Reviewed PSERS' securities policies and procedures in effect during the audit period, including the procedures for identifying and monitoring securities litigation claims;

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<sup>109</sup> “Securities Litigation Alert,” February 14, 2005, Fenwick & West LLP, p. 1.

<sup>110</sup> Ibid., p. 2.

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- Documented information on PSERS' Finance and Corporate Governance Committees and how the Board fulfilled its fiduciary duties regarding securities litigation;
  - Reviewed and documented the custodian bank's responsibilities in the PSERS securities litigation process;
  - Met with three staff members of the Pennsylvania Treasury Department and documented their responsibilities in the PSERS' securities litigation claims process;
  - Reviewed PSERS' list of eligible (potential loss exists) securities litigation claims and randomly selected a sample to test PSERS' pre-settlement monitoring process; and
  - Obtained the list of securities litigation claims that were settled during the audit period and randomly selected 31 claims to verify that the settlement monitoring process was working as intended and 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 PSERS' securities litigation process in particular. We reviewed and tested PSERS' securities litigation policies and procedures. Essentially, the Department and IFS covered similar aspects of PSERS' operations, but took different approaches. Accordingly, our results complement each other.

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**Finding 5.1 – PSERS Was Unable To Demonstrate Case-Specific Monitoring Of The Securities Litigation Process Due To Inadequate Procedures And A Lack Of Documentation.**

We found that PSERS' procedures for securities litigation were inadequate. Without detailed procedures, it is difficult for PSERS to ensure that securities litigation claims are settled timely, and that monies owed are received and properly recorded.

PSERS adopted its first securities litigation policy in 1999. The Board adopted the current policy, *Securities Litigation Policy of the Commonwealth of Pennsylvania Public School Employees' Retirement Board*, in 2003 and amended it one year later. PSERS' procedures, *Steps in Securities Litigation Process for PSERS*, outline the process for implementation of the Board's policy. In 2004, the Board moved all securities litigation decision-making from the Finance Committee to a newly established Corporate Governance Committee. The Board's bylaws outline the Corporate Governance Committee's responsibilities.

Our review of the Board's policy and PSERS' procedures pertaining to securities litigation and the bylaws for the Corporate Governance Committee revealed two deficiencies. The first is that no charter exists for the Corporate Governance Committee. The second is that the procedures do not contain sufficient detail for staff to properly monitor the securities litigation process. Specifically, the *Steps in Securities Litigation Process for PSERS* does not contain specific information as to who is responsible, and what actions are required, for each procedure listed.

Several third parties are involved in PSERS' securities litigation process. These parties include: Institutional Shareholders Service Inc. (ISS), Investor Responsibility Support Services (IRSS), PSERS' custodian bank, and the Pennsylvania Treasury Department. ISS monitors securities litigation for cases for which PSERS may be eligible. IRSS, in conjunction with PSERS' Office of Chief Counsel and Investment Accounting Division, reviews potential claims to determine if PSERS should take a lead or co-lead plaintiff role in litigation. The custodian bank identifies the specific securities eligible for recovery, and provides documentation for the claim to the claims administrator for each case. The Treasury Department monitors the custodian bank through monthly reconciliations and periodic reviews of the process.

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PSERS has an unwritten policy of opting in to all securities litigation. Except for two cases during the audit period, PSERS participated as a class member. After a class action is settled, the custodian bank files a claim. After all participants in the class action have been determined, each participant's share is calculated and PSERS receives its share of the settlement.

As detailed in the following chart, PSERS recovered over \$32 million from securities litigation claims during the audit period.

**Table 7: Funds Recovered through Securities Litigation January 1, 2001 to December 31, 2004<sup>111</sup>**

Year	Claims Paid	Monies Recovered
2001	43	\$ 4,122,110
2002	79	3,738,026
2003	84	11,889,195
2004	105	12,638,981
<b>Total</b>	<b>311</b>	<b>\$32,388,312</b>

PSERS tracked how much money it received in securities litigation settlements during the audit period, and PSERS reported the recovery amount to the Board. However, we found that PSERS could provide the Board with additional information, such as the amount of investment losses, in order to put the recovery amounts in context. We recognize that provable damages in a securities litigation case are different from investment losses and each settlement must be approved by a court, which provides some assurance as to the reasonableness of the settlement amounts. Nevertheless, PSERS' staff should consider what additional information it can provide so that the Board has a complete and accurate representation of the significance of each settlement and can exercise appropriate oversight.

For our test work, we selected a sample of cases to evaluate both pre-settlement monitoring and identification and post-settlement monitoring and reclamation. We requested case-specific documentation of PSERS' process beginning with identification

<sup>111</sup> PSERS internal memos from the Manager of the Investment Accounting Division, detailing quarterly securities litigation settlements collected.

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of the claim, through the custodian bank's filing of the claim, to the time PSERS' share of the settlement is determined, and finally to the posting of the funds by PSERS' Investment Accounting Division.

PSERS' staff could not provide the documentation requested. However, PSERS' staff members did provide us with evidence of monitoring procedures, a monthly pending claims report, which they reconcile with a custodian bank report of settlement funds received. But without case-specific documentation, it is difficult for PSERS to ensure that third parties, such as ISS, IRSS, and the custodian bank, fulfilled their responsibilities and specific claims were timely and appropriately handled. Additionally, if any discrepancies were to occur over payments made to PSERS for securities litigation claims, it would be advantageous for PSERS to be able to produce internal documentation supporting their claim. IFS also discusses PSERS' securities litigation process and also noted a lack of detailed procedures.

**Recommendations**

We recommend that:

- PSERS enhance its securities litigation procedures to include details specifically outlining the roles and responsibilities of all staff and third parties involved in the process;
- PSERS' staff should provide the Board with additional securities litigation information, such as investment losses, so that the Board has a complete and accurate representation of the significance of each settlement and can exercise appropriate oversight;
- PSERS Board formally adopt a charter for the Corporate Governance Committee;
- PSERS obtain monthly reports from the custodian bank, that list the details for each securities litigation claim filed with a claims administrator; and
- PSERS periodically obtain, from a third party, an audit of the custodian bank to ensure that all monies owed to PSERS have been accounted for properly.



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**PSERS' Response**

PSERS disagrees with this finding but will consider the specific recommendations. In doing so, PSERS notes the following:

- PSERS does not believe its current policies and procedures for Class Action Litigation are inadequate. PSERS provided detailed procedures to both the Auditor General and IFS regarding the tracking of class action settlements and the controls it has in place to verify and ensure PSERS has received the money it is entitled to receive. It is PSERS' belief that its controls over settlement collections represent the best practice in the industry. Indeed, IFS recognized that "PSERS' new Securities Litigation Policy sets forth a more deliberative approach;" that PSERS has "established a fairly elaborate and impressive process for identifying and filing potential class action claims, which includes an on-going monitoring component and pre and post-claims filing audits;" and that PSERS' "month-end reconciliation processes" are "a good practice that should alert PSERS to any problems, such as failure to identify a potential claim, prior to the filing deadline." See discussion in IFS Report I at E. Still, PSERS acknowledges that its class action policies can be enhanced to better define the roles and responsibilities of all staff and third parties involved in the process and will endeavor to make such changes.
- Similarly, in the body of the Auditor General's report the comment is made that although PSERS tracked how much money it received in securities litigation settlements during the audit period, it could provide the Board with additional information, such as investment losses, to put the recovery amounts in context for the Board. PSERS will consider changing the format of its report to the Board to provide it additional information regarding the amounts it receives in settlement. In doing so, however, PSERS notes that the amount of its recovery for any class action settlement is determined by the plan of allocation specified in the settlement documents and negotiated by the attorneys for the company and the class, as ultimately approved by the court. The best way to determine if PSERS recovery is reasonable and it has received what it is entitled to recover is to audit its larger class

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action recoveries based upon the terms of the plan of allocation. This procedure can be complex and time consuming and as a result very few pension funds are doing this, particularly given the small size of some of the settlements. Notwithstanding, PSERS began class action settlement audits after the Auditor General's audit period ended in 2004. The combination of PSERS' monthly procedures throughout the Auditor General's audit period and the settlement audits PSERS began in 2005 provides PSERS with the proper controls to assure that it is receiving funds for all cases settled and its settlement amounts are reasonable. In fact, PSERS' audits of large cases have resulted in additional recoveries paid to PSERS due to errors PSERS found during the audits. Some of the more notable additional recoveries include NASDAG Market Maker (additional \$1.9 million) and Cendant (additional \$130,000).

- Finally, with respect to the recommendations concerning PSERS' custodian bank, PSERS believes the current class action reporting by its custodian bank is sufficient. With regards to the third party audit of the custodian bank's class action receipts, PSERS already has completeness controls over the receipt and accuracy of class action receipts and, as indicated previously, PSERS audits larger class action settlements. As such, PSERS believes the added expense of a third party audit of the custodian bank is not necessary. Notwithstanding, PSERS is willing to discuss these recommendations with the State Treasurer, as PSERS' statutory custodian.

**Department of the Auditor General's Comments on PSERS Response**

The Department of the Auditor General is pleased that PSERS has acknowledged that its securities litigation policies could be enhanced to better define the roles and responsibilities of staff and third parties involved and that PSERS will consider changing the format of its report to the Board to provide it with additional information regarding the amounts it receives in securities litigation settlements. Providing the Board with this additional information, including the amount of investment losses, is vital to ensure that the PSERS Board has a complete and accurate representation of the significance of each settlement and can exercise appropriate oversight.

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Furthermore, we also encourage the dialogue between PSERS and the State Treasurer in regards to an independent audit of recovered funds. Finally, PSERS' response does not address our recommendation that the Board formally adopt a charter for the Corporate Governance Committee.

**IFS' Response**

PSERS' Securities Litigation Policy indicates that PSERS may (or has) hired an outside consultant to assist PSERS "in analyzing its interests in both pending and potential securities litigation." One of the outside consultant's responsibilities is to provide PSERS with a damage estimation – or assessment of the Fund's possible recovery (or range of recoveries) in a particular litigation matter. (The damage estimation should not be confused with loss calculations made in connection with a lead plaintiff application.)

If the PSERS Board believes additional contextual information is necessary to evaluate class action settlements effectively, IFS would suggest that staff include, at a minimum, the damage estimation (referenced above) in the settlement information package provided to the Board, if this information is not presently provided.

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

The Department of the Auditor General is pleased that IFS recognizes that PSERS' staff could provide additional contextual information to the Board in order to assist the members in evaluating securities litigation settlements effectively.

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## **Chapter Six      Pennsylvania Investments**

Section 8521(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.**<sup>112</sup> [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.<sup>113</sup>

As a result, PSERS includes a section dedicated to Pennsylvania investments in its annual budget report to the Appropriations Committees of the Pennsylvania Senate and House of Representatives.

### **Objectives and Methodology**

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

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<sup>112</sup> 24 Pa C.S.A. § 8521(e).

<sup>113</sup> Ibid.

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To accomplish this objective, we:

- Reviewed PSERS' annual budget documents for all four audit years as presented to the General Assembly to determine the extent of PSERS' investments in Pennsylvania and to determine whether PSERS appropriately disclosed the amount of its investments in Pennsylvania;
- Reviewed PSERS' *Investment Objectives and Guidelines* document; and
- Interviewed PSERS' Compliance Officer and the Developmental Fund Manager.

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

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**Finding 6.1 – PSERS Did Not Present Information To The General Assembly That Clearly Indicated The Amount PSERS Invested In Pennsylvania.**

Our review of the PSERS budget report for all four audit years and interviews with staff found that PSERS' investments in Pennsylvania crossed all investment classes – equity, fixed income, real estate, and alternative investments (venture capital, private equity, and private debt); however, precisely how much PSERS had invested in Pennsylvania was not clear.

PSERS established two specific programs to encourage investments in Pennsylvania, the Developmental Fund and the Pennsylvania Initiative. PSERS established the internally managed Developmental Fund in April 1995 to “assist emerging minority, women, and Pennsylvania based global and domestic equity investment management firms.”<sup>114</sup> Each manager received an initial allocation of \$15 million with the opportunity to receive up to \$35 million. As of December 31, 2004, there were nine Pennsylvania managers in the Developmental Fund with approximately \$298 million in investments. However, these managers also invest outside of Pennsylvania and the budget does not state how much of the \$298 million is invested in Pennsylvania companies.

PSERS established the Pennsylvania Initiative, a real estate financing program, in October 1992 “to address the void in the mortgage lending market due to the ongoing acquisition of smaller banks throughout the Commonwealth.”<sup>115</sup> The program granted mortgages ranging from \$500,000 to \$5,000,000 to Pennsylvania corporations with terms from 5 to 10 years. PSERS' maximum investment, at any one time, in the Pennsylvania Initiative cannot exceed \$100 million. As of December 31, 2004, the program was valued at \$20 million.

As noted in the *Investment Objectives and Guidelines*, PSERS permitted exceptions for real estate investments in Pennsylvania. These exceptions related to the location and transaction size as follows:

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<sup>114</sup> PSERS' 2005/2006 Budget Report submitted to the General Assembly, “Summary of PSERS' Pennsylvania Investments,” March 1, 2005, p. 49.

<sup>115</sup> *Ibid.*, p. 52.

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Typically, PSERS will limit its investments in any one Primary Metropolitan Statistical Area (PMSA) to ten percent (10%) of the total investment value of its real estate portfolio. However, exceptions may be made for the metropolitan areas of Philadelphia and Pittsburgh, Pennsylvania. After the establishment of a broad economic regional mix within the portfolio, preference may be given to investment throughout Pennsylvania consistent within the content of this Policy Statement.

Individually specified properties shall not generally be less than \$10 million of investment size. In the event portfolios are acquired, individual property sizes generally be a minimum size of \$5 million; however, they may be smaller if all the properties are located at the same site or the property(ies) is (are) within the Commonwealth of Pennsylvania.

A summary of PSERS' Pennsylvania investments from 2001 through 2004 follows:

**Table 8: PSERS' Investments in Pennsylvania Companies and Real Estate (in millions)<sup>116</sup>**

	2004	2003	2002	2001
Equity Investments:				
Stock in Pennsylvania companies	\$593.4	\$631.8	\$480.7	\$652.1
Fixed Income:				
Corporate Securities	138.2	181.8	138.9	180.9
Pennsylvania Initiative	20.0	30.4	33.0	32.4
Real Estate:				
Pennsylvania Property	28.5	56.7	67.8	69.1
<b>Totals</b>	<b>\$780.1</b>	<b>\$900.7</b>	<b>\$720.4</b>	<b>\$934.5</b>

While PSERS invests in Pennsylvania businesses, PSERS is not clearly reporting the amount of these investments to the General Assembly. Specifically we found, for some asset classes, PSERS listed the total market value for the investment managers' portfolio but did not indicate the amount of the portfolio that the manager had invested in Pennsylvania. In other asset classes, PSERS listed amounts *committed* to investment managers rather than the amounts actually *invested* by the managers. Finally, when an

<sup>116</sup> Ibid., pp 51-52.

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amount invested by a Pennsylvania-based investment manager is also invested in Pennsylvania, PSERS lists the amount twice – once as part of the total market value of Pennsylvania-based managers' portfolios and once as part of the total for a particular asset class – without noting that amounts are included in the totals twice. We noted that these discrepancies in the reporting of investments in Pennsylvania affect all asset classes except fixed income.

PSERS reported commitments to seven Pennsylvania-based real estate investment managers totaling \$612.5 million.<sup>117</sup> Similar to the Developmental Fund, this figure includes investments outside of Pennsylvania and the budget reports do not state how much of the \$612.5 million is actually invested in Pennsylvania. Furthermore, \$612.5 million is the amount committed by PSERS and not the amount of monies given to or invested by these seven managers.

For the Pennsylvania-based alternative investment managers (private equity, private debt, real estate, and venture capital) listed in the budget reports; only the amount of PSERS' commitment is included.<sup>118</sup> As PSERS funds commitments over a period of years and may not fund a commitment in its entirety, commitment amount is not synonymous with investment amount. Including a commitment amount without stating how much of that commitment was funded is not useful and may be misleading to the reader.

Finally, although PSERS does track the number of Pennsylvania companies that PSERS invested in and the number of persons employed by those companies, this important information is not included in the budget documents.

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<sup>117</sup> Ibid., p. 52.

<sup>118</sup> We noted that PSERS did provide the market value for the total Pennsylvania based alternative investment manager portfolio, but market value was not provided for each individual investment managers' portfolio nor did PSERS clearly state that these amounts were invested in Pennsylvania only.



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**Recommendations**

We recommend that PSERS clarify information on investments in Pennsylvania that is provided in the budget reports submitted to the General Assembly by:

- Including the amount, when possible, of the Pennsylvania-based managers portfolios that are actually invested in Pennsylvania companies or real estate;
- Indicating the amount of the commitment to real estate managers that has been funded;
- Including the year of commitment, the amount committed, the amount funded, and the amount returned on alternative investments;
- Including the internally tracked information on alternative investments such as the number of Pennsylvania companies PSERS invested in and the total number of persons employed with these companies;
- Precisely stating how much of the total market value listed for Pennsylvania-based managers is also included in the total for that particular asset class; and
- Including the return-on-investment for Pennsylvania investments versus all investments by PSERS.

**PSERS' Response**

PSERS disagrees with this finding but will consider the specific recommendations. In doing so, PSERS notes the following:

- Annually, in conjunction with its budget materials, PSERS has and will continue to provide extensive information to the General Assembly on its Commonwealth investments. The information provided clearly notes:

“PSERS has a continuing commitment to Pennsylvania companies in two specific ways:

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- 
1. Contracting with Pennsylvania-based investment advisor companies
  2. Investing in Pennsylvania-based companies”
- PSERS’ commitment to Pennsylvania-based investment advisor companies, where fiduciarily prudent, shows its commitment to have managers based in the Commonwealth manage the assets of the Fund.
  - PSERS’ investment in Pennsylvania-based companies, where fiduciarily prudent, shows the amount of assets actually invested by the Fund in Pennsylvania regardless of whether the manager is based in Pennsylvania or not.
  - Finally, as for the format and content of PSERS’ Commonwealth investment reports to the General Assembly, PSERS notes that the PSERC does not specify either. Nor are there any national best practices to fall back on as evidenced by the fact that IFS was not asked to comment on this area. In light of the fact, however, that the State Employees’ Retirement System (SERS) has an identical requirement to report its Commonwealth investments to the General Assembly, it appears that an agreed upon uniform reporting format to be used by both SERS and PSERS would be considered a “best practice”. As such, PSERS will endeavor to work with SERS to develop such a uniform format.

**Department of the Auditor General’s Comments on PSERS’ Response**

We are not disputing that PSERS has made a conscientious effort to invest in Pennsylvania but we continue to assert that PSERS is not accurately reporting these investments to the General Assembly. Section 8521(e) of the PSERS Retirement Code states that PSERS must submit a report identifying the “nature and amount of all existing investments” it has in Pennsylvania.<sup>119</sup> Our finding outlined the areas where PSERS was not clear in its reporting of investments in Pennsylvania. By implementing the recommendations we made, PSERS would provide the General Assembly with the

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<sup>119</sup>24 Pa.C.S. § 8521(e).

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detailed information that was intended by this provision of the Retirement Code. We agree that working with SERS to develop a uniform reporting format would be beneficial in ensuring that both systems provide useful information to the General Assembly.

**IFS' Response**

IFS did not respond to this finding.

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## **Appendix A**

### **Pennsylvania Department of the Auditor General Survey**

*Appendix A*

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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 its board composition.

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

<b>Relationship with the Executive Branch</b>	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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<b>Budgetary, Personnel, and Procurement Independence</b>			
	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
<b>If No</b> , is your system required to obtain approval from another state agency to procure supplies, equipment and services?	9*	7*	11
<b>If No</b> , 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
<b>If No</b> , 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
<b>System Board</b>	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**

<b>Pension Fund</b>	<b>Independent Budgetary Authority</b>	<b>Independent Personnel Authority</b>	<b>Independent Procurement Authority</b>
Pennsylvania Public School Employees Retirement System	No	No	No
Arkansas Public Employees Retirement System	No	No	No
California Teachers Retirement System <sup>1</sup>	Yes	Partial <sup>2,3</sup>	Yes
Colorado Public Employees Retirement Association <sup>1</sup>	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 <sup>1</sup>	No <sup>2</sup>	No	Partial <sup>4</sup>
Kansas Public Employees Retirement System	No	Partial <sup>5</sup>	No
Louisiana State Employees Retirement System	No	Partial <sup>6</sup>	Yes
Louisiana Teachers Retirement System	No	Partial <sup>6</sup>	Yes
Maryland State Retirement and Pension System <sup>1</sup>	No	No	Partial <sup>7</sup>
Massachusetts State Employees Retirement System	Yes	Yes	Yes
Massachusetts Teachers Retirement Board	No	Yes	No
Mississippi Public Employees Retirement System <sup>1</sup>	No	No <sup>2</sup>	No <sup>2</sup>



Commonwealth of Pennsylvania  
Public School Employees' Retirement  
System

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Missouri State Employees Retirement System <sup>1</sup>	Yes	Yes	Yes
Nebraska Retirement System	No	No	No
Nevada Public Employees Retirement System <sup>1</sup>	No	Partial <sup>8</sup>	No <sup>2</sup>
New Mexico Public Employees Retirement Association	No	No	No
Ohio Public Employees Retirement System <sup>1</sup>	Yes	Yes	Yes
Ohio School Employees Retirement System	Yes	Yes	Yes
Ohio State Teachers Retirement System <sup>1</sup>	Yes	Partial <sup>9</sup>	No <sup>2</sup>
Oklahoma Public Employees Retirement System	No	No	No
Oregon Employees Retirement System <sup>1</sup>	No	No	No <sup>2</sup>
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

- <sup>1</sup> System participated in both the Independent Fiduciary Service survey and the Pennsylvania Department of the Auditor General survey.
- <sup>2</sup> Independent Fiduciary Service survey results, as noted in its report, differ from the survey results obtained by Pennsylvania Department of the Auditor General.
- <sup>3</sup> 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.

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- <sup>4</sup> 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.
- <sup>5</sup> 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.
- <sup>6</sup> 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.
- <sup>7</sup> 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.
- <sup>8</sup> 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. .
- <sup>9</sup> 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**

<b>Pension System</b>	<b>Governing Board</b>	<b>Board Size</b>	<b>Ex-Officio Members</b>	<b>Appointed by Governor</b>	<b>State Legislature Members</b>
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 <sup>1</sup>	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 <sup>2</sup>	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 Public School Employees' Retirement System**

#### **PSERS Report I Department of the Auditor General Objectives**



INDEPENDENT FIDUCIARY SERVICES, INC.

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**Independent Fiduciary Services, Inc.**

**Investment Fiduciary Review  
of the  
Pennsylvania Public School Employees Retirement System  
  
PSERS 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 School Employees Retirement System PSERS 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 objectives/tasks defined in the April 14, 2005 Agreement for Investment Fiduciary Review Services.<sup>1</sup> The discussion and analysis of the objectives/tasks other than the DAG Supporting Objectives, i.e., the PSERS Objectives is

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<sup>1</sup>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

contained in a separate report (“PSERS 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 PSERS 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 E. Exhibit F contains the formal response of the DAG to IFS’ PSERS Report I.

## **Section I.**

### **Executive Summary**

#### **Basis for the Review**

The Commonwealth of Pennsylvania Public School Employees' Retirement System (referenced interchangeably in this document as "PSERS" or the "System") provides retirement, disability and survivor benefits for Pennsylvania public school employees. PSERS is governed by a Board of Trustees. 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 PSERS' operations and investment program.

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

The Department of the Auditor General ("DAG"), PSERS and SERS entered into an Agreement for Investment Fiduciary Review Services, dated April 14, 2005 (the "Agreement"), which provides for fiduciary reviews of PSERS and SERS by IFS to complement the performance audits of PSERS and SERS simultaneously conducted by DAG. The IFS Objectives in support of the Auditor General's Performance Audit (the "DAG Supporting Objectives") addressed in this Report ("PSERS 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 "PSERS Objectives") are addressed in PSERS 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 PSERS Objectives on December 14, 2005. Preliminary comments on the DAG Supporting Objectives were received from PSERS on December 7, 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 PSERS

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 of the Agreement, a first draft for review and discussion on the DAG Supporting Objectives and the PSERS Objectives was submitted on January 19, 2006. Additional written comments were received from DAG during the month of March, 2006.<sup>2</sup> Written comments were received from PSERS on the DAG Supporting Objectives on December 7, 2005 and on March 1, 2006 regarding the PSERS Objectives with further comments on the DAG Supporting Objectives and discussed with PSERS on March 6, 2006.

In accordance with Amendment No. 2 to the Agreement, IFS submitted a second draft for review and discussion on April 14, 2006. PSERS submitted their formal written comments on May 26, 2006 and DAG submitted their formal written response on June 14, 2006. PSERS' 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 PSERS Board on August 4, 2006 and received final Board comments on August 11, 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, PSERS 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. Clay and his staff for all of their time and cooperation during our review. We especially thank Mr. Halke for coordinating the project and seeing to our needs and numerous requests for information.

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<sup>2</sup> March 3rd, 13th, 15<sup>th</sup> and 16<sup>th</sup>.

## **Key Findings and Recommendations Regarding DAG Objectives**

### ***I-A. Organizational Structure and Resources***

PSERS is governed by a 15-member Board, a body that is larger than most of its peer retirement systems' governing bodies. However it does not appear that the size of the Board has impaired its efficiency or effectiveness. The Board's membership is representative of the System's several stakeholders: active members, retirees, contributing employers and the legislative and executive branches. We note, however, that almost half the Board members may act through designees, and many of those Board members have named multiple designees. This practice could impair the Board's continuity. The law does not require that any Board member have investment expertise. IFS has therefore recommended that the Board support legislation requiring that at least one of the Governor's appointees to the Board have such expertise.

The Board has not adopted a formal statement of governance principles. IFS recommends that the Board do so in order to articulate how authority to act, to recommend and to monitor is allocated among the Board, key staff and outside service providers. As part of the process, the Board should consider delegating some decision-making authority regarding individual administrative and investment matters to qualified staff, subject to policies set and overseen by the Board.

While the Board has nine standing committees, the meeting format facilitates Board members' attendance at meetings of committees to which they do not belong. We recommend that the Board consider restructuring the meetings to allow committees to function as small groups. We also recommend that the Board establish an Audit Committee separate from the Budget Committee. The existing decision-making structure whereby committees make recommendations while the Board retains decision-making authority should be preserved.

PSERS management has used the internal audit function primarily as a consultant/troubleshooter rather than the traditional independent assurance function. We recommend that the identity, role and purpose of the internal audit function at PSERS be changed to be more in line with the primary purpose of internal audit, i.e., monitoring of internal control processes to provide assurance to management. Also, the Board should take steps to establish a distinct Audit Committee; develop an Audit Committee charter; clarify the 'new' role of internal audit through written communication to all staff; issue a formal Internal Audit Charter; increase audit staff to an appropriate level commensurate with the size and risk of the organization; increase technology and other resources available to the Internal Audit function and require PSERS' internal auditor to prepare a periodic audit risk assessment; develop a procedure manual; develop position descriptions; and expand and enhance its information technology audit coverage.

#### ***I-B. Due Diligence Procedures***

We found that PSERS' manager search policies are generally thorough and complete. However, despite the fact that PSERS external public market manager monitoring procedures are also basically complete, given the large number of external portfolios, PSERS does not have enough staff to conduct their monitoring systematically. Staff has had to rely extensively on exception reports from the Custodian and manager certifications. We believe that this process should either be further automated, outsourced or PSERS should hire additional staff so that compliance monitoring (as well as qualitative monitoring) can be done more regularly and frequently for both externally and internally managed accounts. This becomes ever more important as the System increases its investments in more sophisticated strategies, such as the global macro program. 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, PSERS now receives legal advice from its Chief Counsel, who is appointed by the Commonwealth General Counsel, an appointee of the Governor. All PSERS contracts must be approved not only by the Chief Counsel, but also by both the General Counsel and the Attorney General. Changing this regime would require legislation. IFS is fully aware of the difficulties and risks associated with the legislative process; however, IFS believes that the PSERS Board should have access to legal counsel with unconflicted loyalty to PSERS and should seek legislation granting it 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 PSERS 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 PSERS' 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 PSERS 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 PSERS' administrative budget, to be paid from the PSERS 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 PSERS 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 PSERS 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 enhance its "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 Board members are properly subject to a detailed set of procedures for obtaining reimbursement of travel-related expenses. However, the Board's Travel and Education Policy allows each Board member to attend, at PSERS expense, up to five educational meetings outside Pennsylvania each year, a number which appears excessive even though IFS recognizes the value of substantive educational conferences sponsored by reputable organizations, even when such conferences are held outside Pennsylvania. IFS has recommended several specific modifications to the Travel and Education Policy to add controls over the travel practices of the Board.

#### ***I-D. Investment Consultants' Responsibilities***

PSERS 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. We believe that PSERS may want to increase its use of its general investment consultant in areas where it is either short-staffed or would like an independent review (e.g., compliance monitoring, brokerage services, transition management, etc.). It is also important for the consultants to acknowledge their fiduciary duty and to continue to disclose any potential conflicts of interest.

#### ***I-E. Class Action Activities***

We found that PSERS has adopted a comprehensive securities litigation program, with adequate protocols in place to effectively identify, file and monitor securities litigation claims. In our report we recommend that PSERS memorialize the decision-making framework to be employed by the Board, acting through the Corporate Governance Committee, in analyzing potential securities litigation cases. In this regard, we state that the Board should clearly define its goals and objectives and, in addition to the procedural steps that must be taken to initiate litigation, the Board should develop written criteria or guidelines to be used by staff in analyzing potential securities litigation cases.

## **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 Settlement Agreement and the “scope of work” set forth in the Exhibits to the April 14, 2005 agreement, among PSERS, SERS, 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., ERISA<sup>3</sup>, UPIA<sup>4</sup>, UMPERSA,<sup>5</sup> 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 pension fund’s circumstances and functional environment. We note these situations in the text of the report.

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<sup>3</sup> 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.

<sup>4</sup> 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.

<sup>5</sup> 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.

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 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 PSERS, based on certain

factors. Experts will acknowledge that no two pension funds are precisely identical. Some argue that the various differences among the 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 PSERS “peer group” as the pension funds with the greatest level of comparability to PSERS.

To determine comparability and define the PSERS “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 fourteen funds as suitable for participation in the survey pool. Outliers (funds that mirrored PSERS less than some) were also included to assess whether their diminished comparability had a significant impact on the comparison. (See Exhibit A – Customized Peer Group Survey Recipients.) Using commonality of characteristics IFS would typically not consider PSERS’ sister fund (SERS) as a peer. However, we agreed to include SERS because there is an instinctive comparative tendency with respect to “sister funds.”

Eight funds responded, including SERS, (see Exhibit B – Custom 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**

IFS delivered the preliminary discussion documents concerning the DAG Supporting Objectives on November 14, 2005 and the PSERS Objectives on December 14, 2005. Preliminary comments on the DAG Supporting Objectives were received from PSERS on December 7, 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 PSERS objectives were received on January 10, 2006. IFS provided written comments to DAG's comments on the preliminary drafts on January 19<sup>th</sup> 2006. Consistent with IFS' review methodology as stated in Exhibit B to the Agreement a first draft for review and discussion on the DAG Supporting Objectives and the PSERS Objectives was submitted on January 19, 2006. Additional written comments were received from DAG during the month of March, 2006.<sup>6</sup> Written comments were received from PSERS on the DAG Supporting Objectives on December 7, 2005 and on March 1, 2006 regarding the PSERS Objectives with further comments on the DAG Supporting Objectives and discussed with PSERS on March 6, 2006.

In accordance with Amendment No. 2 to the Agreement, IFS submitted a second draft for review and discussion on April 14, 2006. PSERS submitted their formal written comments on May 26, 2006 and DAG submitted their formal written response on June 14, 2006. PSERS'

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<sup>6</sup> March 3rd, 13th, 15<sup>th</sup> and 16<sup>th</sup>.



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 PSERS Board on August 4, 2006 and received final Board comments on August 11, 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 PSERS or DAG and the language in question was not added or changed, such comment(s) are included in this Report. PSERS 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 F) 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.

### **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 PSERS' 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, PSERS 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 PSERS, 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 PSERS' 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 PSERS' internal controls, we did not conduct – or attempt to conduct – a full or formal examination of PSERS' 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 PSERS 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 F 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.<sup>7</sup> We believe the same is true for public pension funds. The need for good public pension fund governance arises from the same types of issues that give rise to the need for good corporate governance.

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<sup>7</sup> Wilshire study 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.

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.<sup>8</sup> 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.<sup>9</sup>

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**
- **Resolutions (Actions on Motions)** - documenting the decisions of the Trustees.

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<sup>8</sup> 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).

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

- **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 Trustees’ 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 trustees 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 PSERS’ 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 PSERS, 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 PSERS, the internal audit function.

## 2. Board and Committees

While in some jurisdictions a single trustee has complete 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.<sup>10</sup> The PSERS Board was established and is governed by the PSERS Retirement Code, Title 24 of the Pennsylvania Consolidated Statutes. Section 8501(a) of the Retirement Code states, “The board shall be an independent administrative board,” and Sections 8501 and 8502 grant specific powers and imposes duties on the Board, including:

- Power to contract for services of professionals;<sup>11</sup>
- 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;

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<sup>10</sup> Exhibit D lists the 11 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).

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

- Duty to publish annual financial statement of the System; and
- Duty to provide for an annual audit by 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 [PSERS] fund and full power to invest same. . . ." <sup>12</sup>

***PSERS' Board Structure Gives all Stakeholders a Voice,  
Rendering the Board Larger than the Boards  
of Comparable Public Funds***

PSERS is governed by a Board that consists of fifteen (15) members, as follows:

- The Secretary of Education, *ex-officio*;
- The State Treasurer, *ex-officio*;
- The Executive Director of the Pennsylvania School Boards Association, *ex-officio*;
- Two persons appointed by the Governor;
- Three active professional members of the System, elected by the professional members;
- One active non-professional member of the System, elected by the non-professional members;

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<sup>12</sup> The Public School Employees' Retirement Code, 24 P.S. § 8101 *et seq.* ("Retirement Code"), Sec. 8521(a).



- One retiree, elected by the retirees;
- One school board member, elected by the members of the school boards;
- One majority and one minority member of the Senate, designated by the President Pro Tem; and
- One majority and one minority member of the House of Representatives, designated by the Speaker.

This is a large Board. To support this conclusion, in Table I-A-1 we examine the composition of 28 boards<sup>13</sup> including SERS' and PERS' customized peer group and the Teachers Retirement System of Texas.<sup>14</sup> 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.<sup>15</sup> MOSERS won the award.

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<sup>13</sup> Both boards for LACERA and Oregon were considered.

<sup>14</sup> An explanation of how the peers group was constructed is provided in the Introduction to this Report.

<sup>15</sup> Awarded by Money Letter, a publication of Institutional Investor Inc., in their 5th Annual Public Fund Award program.

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 <sup>16</sup>	Annual	Yes
State of Connecticut Trust Funds	Treasurer is Sole trustee	5 - IAC See note <sup>17</sup>	IAC Chair appointed by Governor		Yes on the Advisory Board
Illinois TRS	11	4	No- Statutory Designee <sup>18</sup>	Term of the statutory designee	Yes
Iowa PERS	11 <sup>19</sup>	6 <sup>20</sup>	No – Chair elected by voting members of Board <sup>21</sup>	Annual	Yes
LACERA (has two boards – BOR & BOI)	9 <sup>22</sup> /9	N/A	Municipal board – Chair elected by board members	Annual	Yes
Md. State Retirement and Pension System	14 <sup>23</sup>	5	No – Chair elected by Board <sup>24</sup>	Annual	Yes

<sup>16</sup> Chair and Vice Chair are elected by the Board annually. (Retirement Code Sec. 8501(a); Bylaws §§ 3.1 and 3.2.)

<sup>17</sup> 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.

<sup>18</sup> 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.

<sup>19</sup> There is an Investment Board (11 members, seven voting and four non-voting) and a Benefit Advisory Committee (nine voting and two non-voting)). The Investment Board members are designated as the trustees of the retirement fund.

<sup>20</sup> 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.

<sup>21</sup> 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.

<sup>22</sup> Retirement Board has nine member and two alternates. The Investment Board has nine members.

<sup>23</sup> Maryland Code - §21-104.

<sup>24</sup> Maryland Code - §21-105.

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
Mass PRIM	9	2	Treasurer is statutory Chair	Term of the statutory designee	Yes
Minnesota State Board of Investment	4 <sup>25</sup>	0	Governor is the Chair	Term of the statutory designee	No
Mississippi PERS	10 <sup>26</sup>	1	No – elected by Board <sup>27</sup>	-	Yes <sup>1</sup>
Missouri Public School	7	3	No – elected by Board	Annual	
MOSERS	11	2 <sup>28</sup>	No – Chair and Vice Chair elected by the Board <sup>29</sup>	Annual – limited to two consecutive terms	Yes
Nevada Public Employees	7	7 <sup>30</sup>	No – Chair elected by Board <sup>31</sup>	Annual	Yes
Virginia Retirement System	9	5 <sup>32</sup>	Yes <sup>33</sup>	Two years not to exceed two consecutive terms.	No

<sup>25</sup> Comprised of the Governor, the State Auditor, the Secretary of State, and the Attorney General.

<sup>26</sup> 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.

<sup>27</sup> §25-11-15(9)

<sup>28</sup> Missouri Code - § 104.450.

<sup>29</sup> 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.

<sup>30</sup> 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.

<sup>31</sup> § NRS 286.150(3).

<sup>32</sup> 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.

<sup>33</sup> 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.

<b>TABLE I-A-1 – REVIEW OF BOARD SIZE, MEMBER REPRESENTATION GOVERNOR'S APPOINTMENT AUTHORITY AND TERM OF CHAIR</b>					
<b>Pension Fund</b>	<b>Board Size</b>	<b>Members Appointed by the Governor</b>	<b>Governor Designates Chairman?</b>	<b>Chair's Term</b>	<b>Member Representation of the Board</b>
<i>State of Wisconsin Investment Board</i>	9 <sup>34</sup>	6 <sup>35</sup>	No – Elected by the Board	<i>Annual</i>	Yes
<i>Wash. State Investment Board.</i>	10 <sup>36</sup>	3 <sup>37</sup>	No – Chair elected by Board	<i>Annual</i>	Yes
<i>Arizona State Retirement System</i>	9	9 <sup>38</sup>	No - Chair Elected By Board	<i>Annual</i>	Yes
California State Teachers Retirement System	12 <sup>39</sup>	5 <sup>40</sup>	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 <sup>41</sup>	3- IAC See note <sup>42</sup>	N/A	<i>N/A</i>	<i>N/A</i>

<sup>34</sup> 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).

<sup>35</sup> 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](#).

<sup>36</sup> 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

<sup>37</sup> All three must be retirement system members (one retired and two active)

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

<sup>39</sup> 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.

<sup>40</sup> 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.

<sup>41</sup> The Treasurer has an Investment Advisory Committee (IAC) is composed of the director of commerce, the director of the department of management and budget, or their duly authorized representatives, and three 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.

<sup>42</sup> 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 three public members appointed by the governor with the advice and consent of the senate.

<b>TABLE I-A-1 – REVIEW OF BOARD SIZE, MEMBER REPRESENTATION GOVERNOR'S APPOINTMENT AUTHORITY AND TERM OF CHAIR</b>					
<b>Pension Fund</b>	<b>Board Size</b>	<b>Members Appointed by the Governor</b>	<b>Governor Designates Chairman?</b>	<b>Chair's Term</b>	<b>Member Representation of the Board</b>
<i>New York State Teachers Retirement System</i>	10 <sup>43</sup>	0	No- "President" elected by Board	Annual	Yes
<i>North Carolina Retirement System<sup>44</sup> (has Two Boards)</i>	14 & 17 <sup>45</sup>	10 & 13	No- Elected by the Board	Annual	Yes
<i>Ohio Public Employees Retirement System</i>	11 <sup>46</sup>	4	No – Chair elected by Board	Annual	Yes
<i>State Teachers Retirement System of Ohio</i>	11 <sup>47</sup>	1	No – Chair elected by Board	Annual	Yes
<i>Oregon Public Employees Retirement Fund<sup>48</sup></i>	6 <sup>49</sup>	4 <sup>50</sup>	No – Chair elected by Board	Annual	No

<sup>43</sup> 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.

<sup>44</sup> 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. National Guard Pension Fund, and the Legislative Retirement System. Collectively these are referred to as the North Carolina Retirement Systems.

<sup>45</sup> 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).

<sup>46</sup> Six elected, four appointed and one statutory.

<sup>47</sup> Five elected contributing teacher members; two elected retired teacher members; an investment expert appointed by the governor [one]; an investment expert appointed jointly by the speaker of the House and the Senate president [one]; an investment expert designated by the treasurer of state [one]; and the superintendent of public instruction or her designated investment expert [one].

<sup>48</sup> 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.

<sup>49</sup> 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.

<sup>50</sup> 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.

<b>TABLE I-A-1 – REVIEW OF BOARD SIZE, MEMBER REPRESENTATION GOVERNOR'S APPOINTMENT AUTHORITY AND TERM OF CHAIR</b>					
<b>Pension Fund</b>	<b>Board Size</b>	<b>Members Appointed by the Governor</b>	<b>Governor Designates Chairman?</b>	<b>Chair's Term</b>	<b>Member Representation of the Board</b>
<i>Oregon Public Employees Retirement System</i> <sup>51</sup>	5	3	No	Annual	Yes
Texas Teachers Retirement System	7	7 <sup>52</sup>	Yes <sup>53</sup>	At pleasure of Governor	Yes
<b>Median</b>	<b>9.5</b>	<b>4</b>			

The median board size among the sample group reviewed is 9.5.<sup>54</sup> Thus, only two boards, Colorado PERA and one of the North Carolina Boards are larger than the PSERS. 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.

While one might expect that such a large board would be an unwieldy and inefficient decision-making body, our interviews with Board and staff members and our analysis of the Board's decision-making process did not indicate that the Board's size itself is the source of difficulty.

The composition of the Board includes the several stakeholders in the System: active participants, retirees, contributing employers and the Commonwealth's executive and legislative branches. This is consistent with the majority of the boards identified in Table I-A-1 and Exhibit D; some number of board members is elected by the membership. The breadth of representation

<sup>51</sup> This Board is not responsible for investments. It is responsible for the administration of the retirement system.

<sup>52</sup> 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.

<sup>53</sup> A member of the Board is designated by and serves at the pleasure of the Governor (§ 825.201 Texas Code).

<sup>54</sup> For the funds with a Sole Trustee, Connecticut and Michigan, we reviewed the Investment Advisory Boards that provide investment advice to the State Treasurer.

is unique among the peer group. No one constituency dominates the Board, meaning that Board decisions must reflect a consensus of several constituencies.

The Board's Chair and Vice Chair are elected annually by the Board.<sup>55</sup> Having an elected Chair, as opposed to a chairperson designated by an outside appointing authority (as is the case at the State Employees' Retirement System), is consistent with establishing the Board's autonomy and independence.

Unlike several of the sample peer group boards, the PSERS Board does not include any board members who are required by law to have investment or financial expertise. As reflected in the footnotes to Table I-A1, 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).

We understand that the Governor has historically considered such expertise in naming appointees, but reliance on individual incumbents' judgment is no substitute for a legal requirement. Some Board members have 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. Concerns were also expressed that it would be difficult to define "expertise" meaningfully. On balance, IFS believes that requiring investment expertise on the part of at least some<sup>56</sup> members of the Board would enhance the Board's ability to set and to revise investment policy and to monitor its execution, and that "investment expertise" can be

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<sup>55</sup> Retirement Code Sec. 8501(a); Bylaws Secs. 3.1 and 3.2.

<sup>56</sup> 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.

defined either broadly or by reference to experience in particular segments of the finance industry.

Recommendation IA-1	PSERS Response
<p><i>The Board should support legislation requiring that at least one of the Governor's appointees to the Board have investment expertise.</i></p>	<p>The Board believes this is a matter for the General Assembly since it requires legislative action. The Board notes, however, that it has been the long standing practice of the Commonwealth's Governors to appoint Board members with investment experience, as evidenced by the current gubernatorial appointees to the Board.</p>

Finally we note that only one of the peer group Boards includes legislators. While this renders the PSERS 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 standard of fiduciary responsibility as the rest of the Governor's appointees and the State Treasurer. If one considers that the legislature participates in various "settlor" functions regarding PSERS 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<sup>57</sup> in unionized private sector industries. The legislative members of the Board can be effective advocates for PSERS as its administrative budget goes through legislative review by the General Assembly.

***The Designee System Creates the Potential  
 for Lack of Continuity***

Retirement Code Section 8501(a) and Section 2.2 of the Board's Statement of Organization, Bylaws and Other Procedure ("Bylaws") permit the Board's ex-officio and

<sup>57</sup> "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.



legislative members to appoint one or more designees “to act in his or her stead at any meeting of the Board or of any committee thereof or with respect to official business and activities of the Board conducted outside of meetings.” Thus, seven of the Board’s 15 members are authorized to act through designees, and many have named more than one designee.<sup>58</sup> Board members generally designate senior staff members for this role,<sup>59</sup> and meet with their designees to review matters that are expected to come before the Board for decision. The involvement of different designees for Board members has the potential to impair the Board’s continuity in view of the fact that so many Board members can act through designees, and the multiplicity of designees appointed for that purpose. Moreover, while the Retirement Code subjects the members of the Board to a rigorous standard of prudence<sup>60</sup> it is not clear that Board member designees are subject to the same standard, as discussed in Section 1-C(2) below.

### ***PSERS Does not Have a Formal Governance Document***

PSERS has adopted and posted on its website a broadly worded Mission Statement which provides as follows<sup>61</sup>:

*The Board of Trustees and the employees of the Public School Employees’ Retirement System serve the members and stakeholders of the System by:*

- *Prudently investing the assets of the Fund;*
- *Maintaining a financially sound Fund;*
- *Providing timely and accurate payment of benefits;*

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<sup>58</sup> At least one Board member has named four designees.

<sup>59</sup> The Bylaws require that the Treasurer and the Executive Secretary of the School Boards Association designate members of their staffs. The Secretary of Education’s designee(s) must be Commonwealth employees appointed by either the Governor or the Secretary.

<sup>60</sup> Retirement Code Sec. 8521(a).

<sup>61</sup> As amended and approved by the Board on December 9, 2005, PSERB Resolution 2005-63.

- *Clearly communicating members' and employers' rights and responsibilities; and*
- *Effectively managing the resources of the System.*

The Board has also adopted a Statement of Organization, Bylaws, and Other Procedure (“Bylaws”) codifying basic procedural rules for the Board’s functioning and either restating or amplifying elements of the Retirement Code and other laws governing the Board. However, there is no formal statement of governance principles delineating the roles and responsibilities of key staff (the Executive Director, the Chief Investment Officer, and Portfolio Managers), service providers (investment consultant, legal counsel) and the Board with respect to the administration and management of the fund. A statement of principles and policies articulating the allocation of authority to recommend, to monitor and to decide among the various elements of the senior leadership enables each segment of the leadership to focus on performing its tasks, confident that all key governance tasks are accounted for. The absence of such a statement can result in both duplication of effort and gaps in carrying out those functions.

Our review of the Board’s minutes and our interviews indicate that PSERS’ Board members act on a broad range of issues. In some instances, management issues are presented to the Board that would be more suitable for action by executive staff pursuant to a delegation of authority from the Board, rather than Board action. For example, the minutes of the Board’s June, 2004 meeting show that the Personnel Committee, and ultimately the full Board, formally considered and voted upon compensation increases and promotions for mid-level staff members.

In addition, the full Board votes on each individual investment in the area of private equity and real estate, as well as decisions regarding certain mortgages on properties and sales of individual properties.<sup>62</sup> 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. However making individual investment decisions requires time-consuming and detailed analysis. Almost without exception, the minutes

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<sup>62</sup> See, for example, minutes of PSERS Board meetings of January, March and June, 2004.

show that the Board adopts the staff’s recommendations with respect to individual investments. It is unclear how bringing to the Board individual investment commitment decisions in the private equity, real estate and alternative investment asset classes enhances the quality and efficiency of decision-making.<sup>63</sup> Delegating these issues to 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.<sup>64</sup>

Recommendations IA-2 and IA-3	PSERS Response
<i>The Board should develop and adopt a formal Statement of Governance Principles.</i>	The Board agrees and will endeavor to institute this recommendation.
<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 and appropriate reporting requirements to the full Board or an appropriate Committee, as well as certain administrative decisions on personnel and other matters, subject to oversight by the Board or an appropriate committee.</i>	The Board will consider this recommendation. It should be noted, however, that the Board has already taken steps in this direction in that the Board does not require formal presentations on new investments by existing real estate, private equity and alternative investments partnerships. In addition, one goal of the planned Request for Proposal for an investment personnel consultant is to develop policies and procedures to enable delegation of certain investment personnel actions to the Staff. It is also anticipated that the suggested Statement of Governance Principles recommended above, will document and incorporate new and existing delegations of authority on a wide spectrum of administrative matters, including benefits, budgetary, procurement and operational matters.

<sup>63</sup> Our observation is limited to private equity, real estate and alternative investment because those are the asset classes in which the Board is directly involved in individual investment decision-making.

<sup>64</sup> IFS is not aware of any impediment in the Retirement Code or elsewhere in Pennsylvania law which would prohibit such a delegation, and neither PSERS staff nor the Auditor General’s office has brought such a provision to IFS’s attention after inquiry.

***The PSERS Board Does not use Committees  
in a Way that Would Improve Efficiency and Effectiveness***

The Board has the authority to create and abolish committees by amending the Bylaws. Under the Bylaws, the Board's Chair, who is elected annually by the Board, determines the number of members of each committee, assigns Board members to committees and is an *ex-officio* voting member of each committee. Article IV of the Bylaws establishes nine standing committees of the Board:

- Appeals/Member Services
- Audit/Budget
- Bylaws/Policy
- Corporate Governance
- Elections
- Finance
- Health Care
- Personnel
- Technology Steering

The Bylaws permit all Board members to attend committee meetings, and while the Finance Committee is the only committee that is formally a "committee of the whole," it is our understanding that as a practical matter most Board members (or their designee(s)) attend at least some Committee meetings (particularly meetings of the Health Care and Appeals Committees), which are generally held the day before the Board meetings. However, only formally appointed Committee members may vote at the Committee meeting.

The PSERS Board implements this structure by usually conducting its regular meetings over two days, with most of the Board attending Committee meetings on the first day and, if needed, the second day, followed by a formal Board meeting generally lasting approximately an hour on the second day. Not every committee meets every time there is a full Board meeting.

During 2004, the Board conducted eight regular meetings.<sup>65</sup> The Finance Committee – the committee of the whole – met on each occasion. The other committees met an average of four times, with the Appeals/Member Benefits Committee meeting the most times (seven) and the Personnel Committee meeting only once. The Board meeting packet sent to every Board member contains the agenda and materials for every committee meeting, as well as the full Board meeting.

There does not appear to be a legal requirement to schedule committee meetings for the day before regular meetings of the full Board, a practice that, combined with the distribution of materials regarding every committee to all Board members, facilitates Board members' attendance at meetings of committees to which they do not belong. However, it is our understanding that committee meetings are scheduled this way to facilitate scheduling and attendance by those Board members who have to travel. Nonetheless, this process blunts the Board's ability to maximize the principal advantages of a committee structure – the use of small groups of Trustees to conduct a preliminary analysis of critical issues, developing an expertise in the areas on which they focus.

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<sup>65</sup> Section 5.4 of the Bylaws requires six Board meetings per year.

Recommendation IA-4	PSERS Response
<p><i>The Board should consider restructuring its meeting format so as to allow the Committees to work as small groups to develop analysis and recommendations for the full Board.</i></p>	<p>The Board will consider this recommendation. On critical issues or long term projects, the Board has already moved in this direction having utilized agency committees (comprised of Board members and PSERS' staff), which are recognized in the Board's Bylaws, (see Article IV, Section 4.5), to develop proposals for the Board's consideration, through its existing committee structure. A current example is the PSERS Policy Review Agency Committee that is reviewing and revising, when necessary, all of PSERS existing policies. Two notable past examples are the separate agency committees that developed the new plan design for PSERS Health Options Program (HOP) and participated in incorporating Medicare Part D into the HOP plan design.</p>

The Committees do not have charters as such. The Bylaws contain reasonably specific descriptions of the subject matters within each Committee's jurisdiction. As is typical among public pension funds, the Committees do not have decision-making authority, although Section 4.3 of the Bylaws authorizes the Board to delegate authority to Committees, subject to the limits articulated in Section 4.6 (which bars the Board from delegating authority to change the Bylaws, modify or repeal a Board resolution or take action that is non-delegable as a matter of law). Rather, each Committee reviews, reports to the Board and makes recommendations to the Board with respect to the subjects within its jurisdiction, and the Board then acts on the recommendation. This practice of committee recommendation followed by Board action is typical of public funds. In the case of PSERS, the practice assures that final decision-making authority on all matters requiring Board action rests with the entire Board, with its diverse makeup. Since small committees could not, by virtue of their size, include all of the constituencies, we believe the Board's retention of decision-making authority is a sound practice

provided, as indicated above, that the Board delegates implementation decisions to appropriate staff or managers as discussed above.

The Finance Committee is a committee of the whole. Given the range of issues it deals with, especially in light of the extensive use of internal management at PSERS, establishing one or more subcommittees to act regarding specific asset classes or other categories of decisions could allow the Board to retain control over certain issues without requiring that the entire Board be involved with them. Matters such as private equity and real estate would be particularly appropriate for a subcommittee to be given authority over. We recommend that the use of subcommittees be part of the process of preparing a Governance Statement as recommended above.

Finally, we note that a single committee has authority over both budget and audit function. While the committee does not have any formal decision-making authority regarding the budget, its role in formulating the budget renders it inappropriate for the same body also to have jurisdiction over the audit process in that oversight of the process of auditing should be conducted by a body separate from the body that makes recommendations regarding the expenditures to be audited.

Recommendation IA-5	PSERS Response
<i>The Board should develop an Audit Committee separate from the Budget Committee.</i>	The Board will consider this recommendation.

***The PSERS Board's Meeting Minutes Reflect,  
in Text and by References,  
the Substance or Basis for its Decisions***

A public pension fund board should maintain minutes which record its decisions and the basis for those decisions. Well-maintained minutes create the basic historical record of those decisions, which is necessary both for reference and for transparency of its decisions. Consistent

with Section 7 of Pennsylvania's Sunshine Act,<sup>66</sup> the Bylaws require the maintenance of minutes of every open meeting, and the Board in fact maintains those minutes. While our review of a sample of meeting minutes shows that they frequently record Board actions in terms of approval of reports or other documents that are not attached to the minutes, PSERS staff advises that the attachments are archived and readily available for reference. Important investment-related documents approved by the Board, such as the Investment, Development Fund and Proxy Voting Guidelines are available to the public on the PSERS website.

### **3. Information Technology Systems for 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* 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.

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, PSERS' custody bank, but transactions for real estate and private equity investments in private markets do not settle through the custody bank and are maintained elsewhere. These transactions must be communicated to Mellon for aggregation.

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<sup>66</sup> 65 Pa. C.S. Sec. 706



Similarly, the PSERS Office of Financial Management (OFM) gathers the data from the various sources and posts it to the Lawson General Ledger via summary journal entries in order to capture aggregate investment information in the System's *financial* accounting system to enable preparation of GAAP financial statements and other management reports. PSERS also posts summary data to the Financial Control Systems (FCS) database to maintain investment data from various sources in one so-called 'investment accounting database.' Thus, PSERS does not have an 'all-in-one' investment accounting system that automatically collects and records transactions as they are executed and from all sources. This is not uncommon in the industry and is characteristic of funds that by nature invest in numerous externally managed asset classes. PSERS expects the FCS investment accounting system to include all assets by June 2007 upon the integration of alternative investments into FCS.

***The Tri-Party Manager Reconciliation Process  
Appears to be Sufficient  
to Identify and Correct Differences***

Key internal control processes that are essential to provide checks and balances on the investment accounting process involve Mellon, PSERS 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 performed rigorously and under the guidance of written procedures and supervisory reviews.

***PSERS Plans to Make the FCS Investment Accounting  
Application its Official Investment Book of Record***

PSERS' Investment Accounting system and official IBOR (Investment Book of Record) is comprised of a combination of Excel spreadsheets, and custodian prepared records. A fund may have more than one set of investment records for the same transactions and assets, e.g., the custodian's records, the fund's records, the manager's records. One set should be deemed the official set upon which reports are based. For portions of the investment portfolio PSERS has made the FCS investment database the official Investment Book of Record to facilitate control of

investment accounting records when such control points are needed, e.g., when the custody bank changes. PSERS uses FCS as the official book of record for all public market investments (approx. 85% of the investment portfolio). As such, FCS was used to prepare the audited investment portion of PSERS Comprehensive Annual Financial Report (CAFR) for the year-ended June 30, 2005. PSERS plans to convert the IBOR for private markets from the current excel-based system to FCS by June 2007.

Ordinarily, combining the custody and the accounting 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. Giving both of these functions to Mellon to perform would be a conflict of basic separation of duties.

Additionally, PSERS has a substantial amount of internal asset management that tends to justify the need and cost of an investment accounting system. On that basis, we think it is prudent to establish its own systems to allow it to keep the official accounting records for the investments.

Finally, since the PSERS portfolio managers do not rely on the investment accounting system to make investment decisions, location of the IBOR does not impact portfolio management.

Further, we understand that currently PSERS' Investment Accounting utilizes FCS to capture international investment transactions, including local and base currency and foreign exchange contracts, on a monthly basis.

Recommendation IA-6	PSERS Response
<i>PSERS should continue development of an in-house investment accounting system to capture private market investment activity so that all investments are included in its investment accounting system.</i>	PSERS agrees. In fact, the project to create an independent book of record for all assets of the System is a priority and is well on its way to completion.

**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.

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

PSERS has adopted Information Technology Bulletins (ITB) promulgated by the Governor's Office for Information Technology.<sup>67</sup> Additionally, PSERS 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 PSERS consist of manual processes that require human intervention, such as secure door locks to automatic controls that lock workstations after inactivity and require user passwords to unlock. User ids become disabled after five consecutive invalid access attempts. Users are required to change their passwords every 60 days and the system retains a history of six prior passwords to prevent their re-use. In addition, users are able to change their password in the event that they believe it has been compromised. Further, PSERS

<sup>67</sup> The Office of Administration/Office for Information Technology (OA/OIT) is responsible for developing and administering statewide policies and standards governing management and use of the Commonwealth's information technology (IT) resources.

identifies authorized individuals in official Office of Information Technology written policies and procedure bulletins by their role, function and title. All users must sign an acknowledgement that they have read the physical and information security policies.

Recommendation IA-7	PSERS Response
<p><i>Staff should be required to acknowledge by signature the receipt of, and agreement to, all IT policies and procedures.</i></p>	<p>PSERS agrees. In fact, this is already being done through PSERS' new employee orientation program and PSERS' on-line policy for distribution system known as VPC (Vigilant Policy Center) for existing employees.</p>

**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 restore promptly computer applications, operating systems, and data to its most recent state in the event of corruption or accidental erasure.

Again, PSERS has adopted the ITB standards promulgated by the Governor's Office for Information Technology. PSERS uses Sungard, a third party computer service provider, for certain back up services and backup tapes are stored at an off site location in New Jersey. PSERS' written policies and procedures address the types of tape backups performed for its files. These backups consist of full backups on Sunday and daily incremental backups on Monday through Saturday.

Recommendation
<p><i>No recommendation necessary.</i></p>

**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. PSERS' Internal Audit Function**

##### **a. Background**

The Board and management staff are responsible for monitoring control processes. Monitoring roles are typically delegated to the senior staff and to an internal audit department. Part of the role of a properly functioning internal audit department is to perform periodic audits and reviews that are designed to test compliance with management's policies and procedures with an emphasis on internal controls. This description of internal auditing and its role in the monitoring function is consistent with professional guidance on the operations of internal auditing.<sup>68</sup>

Another role of internal audit ("IA") that has evolved and received emphasis of late is that of 'consultant' to management. The PSERS internal auditor focuses much of his resources on the consultant role. In fact, we note that much of his focus since inception has been on troubleshooting and special projects.

***The Current Role of Internal Audit does not  
Provide an Appropriate Level of Assurance to Management  
Regarding the Organization's Overall  
Internal Control Framework***

Some of the characteristics we would normally expect to see regarding the internal audit function include, but are not limited to:

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<sup>68</sup> Standards for the Professional Practice of Internal Auditing, Performance Standard 2120. The Institute of Internal Auditors.

- An Audit Committee of the Board
- An Audit Committee Charter
- An Internal Audit Charter
- An Internal Audit Policy & Procedure Manual
- An annual risk assessment
- An annual risk based audit plan approved by the Audit Committee
- Adequate staffing
- Position descriptions for internal audit staff
- Periodic meetings of audit staff and the audit committee
- Frequent audit reports
- A program of follow up on all audits

We believe that management's past use of internal audit primarily as a consultant/troubleshooter has created an 'assurance vacuum' at PSERS. The identity, role and purpose of internal audit should be changed to be more in line with the primary purpose of internal audit, i.e., monitoring of internal control processes to provide assurance to management.

#### **b. Limited Audit Planning Processes**

One of the most significant challenges confronting PSERS' internal auditor is how to maximize auditing effectiveness with limited resources while balancing established consulting expectations. In meeting this challenge, thorough planning is essential to facilitate the efficient use of staff time and to schedule worthwhile audit activities. Audit planning should be based on a careful assessment of the key risks facing the organization, and culminate in a prioritized audit schedule for Board approval.

### **c. Adequacy of Staffing of Internal Audit**

A survey<sup>69</sup> of over 40 public retirement systems indicates the average size of the internal auditing professional staff is approximately 2.3% of total staff size. At its present level (one professional staff) PSERS' IA does not have the resources to meet its professional responsibilities.

Applying the 2.3% rule of thumb, IA staff size should increase to a total of six or seven audit professionals (2.3% x 290 staff) in order to be at the *average* size for public retirement funds. In addition, the audit professionals should hold appropriate professional certifications. For example, one of these professionals should have the CISA<sup>70</sup> certification.

### **d. Working Smart**

The current economic and fiscal environment is such that Internal Audit also needs to “work smart.” IA should implement techniques that are designed to foster efficiency in internal auditing. When the staff size increases to the recommended number above, efforts should be made to implement “process auditing” (replaces traditional audits of transactions and segmented activities) including integration of all significant aspects of the process (including IT audit work). Working smart could also include streamlining the audit process/practices, staff empowerment, use of technology, self-assessments, team audits, and other opportunities to reduce audit cycle time and improve cost-effectiveness. Working smart also may include outsourcing (after an audit risk assessment is done).

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<sup>69</sup> Association of Public Pension Fund Auditors, 2005.

<sup>70</sup> Certified Information Systems Auditor

Recommendation IA-8	PSERS Response
<p><i>The Board should take steps to establish an internal audit function that is more in-line with mainstream or traditional internal auditing. In that regard the Board should:</i></p> <ul style="list-style-type: none"> <li>○ <i>Establish a distinct Audit Committee of the Board</i></li> <li>○ <i>Develop an Audit Committee charter</i></li> <li>○ <i>Clarify the role of IA through written communication to all staff</i></li> <li>○ <i>Issue a formal Internal Audit Charter<sup>71</sup></i></li> <li>○ <i>Increase audit staff to an appropriate level commensurate with the size and risk of the organization</i></li> <li>○ <i>Increase technology and other resources available to the Internal Audit function</i></li> <li>○ <i>Require Internal Audit to</i> <ul style="list-style-type: none"> <li>○ <i>Prepare a periodic audit risk assessment</i></li> <li>○ <i>Develop a procedure manual</i></li> <li>○ <i>Develop position descriptions</i></li> <li>○ <i>Ensure that the IT risk assessment includes information technology areas such as:</i> <ul style="list-style-type: none"> <li>▪ <i>data centers,</i></li> <li>▪ <i>systems software,</i></li> <li>▪ <i>application systems,</i></li> <li>▪ <i>systems development,</i></li> <li>▪ <i>end-user computing,</i></li> <li>▪ <i>telecommunications, and</i></li> <li>▪ <i>networks.</i></li> </ul> </li> </ul> </li> </ul>	<p>The Board will consider these recommendations. Some of these recommendations, however, would be more meaningful if IFS had detailed the following:</p> <ul style="list-style-type: none"> <li>• The deficiencies in the current position description</li> <li>• The technology and other resources that IFS believes is not already available to the Internal Auditor</li> <li>• The need to re-clarify the role of the Internal Auditor in a written communication to all staff</li> <li>• The deficiencies in the current procedures manual</li> </ul>

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

<sup>71</sup> The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the Board. (Standards for the Professional Practice of Internal Auditing, Attribute Standard 1000. The Institute of Internal Auditors.)



## **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 ERISA covered 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 debate their findings, challenge 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 PSERS Manager Search Procedures for Public Equities and Fixed Income**

***PSERS' Due Diligence Procedures are Thorough and Complete***

Based on our review, PSERS' due diligence process effectively combines the efforts of an experienced and capable staff with a nationally-recognized and well resourced investment consultant. PSERS' staff takes a pro-active role in determining new roles for investment managers and in defining the nature of the assignments for which managers are sought. The staff has good knowledge of the variety of manager styles and strategies available to institutional investors.

The general investment consultant uses (and provides to the Fund) a sophisticated database of investment managers' performance and characteristics (Wilshire Compass). The consultant uses this database to screen for candidates to fill assignments in the Fund's investment structure. Typically, the consultant provides PSERS' staff with a "long list" of 10 to 30 candidates for review. Staff then reviews that "long list," eliminates those candidates that are not as strong, and adds any new names that staff believes deserve consideration. Staff has the consultant evaluate the contribution each candidate might make to the diversification of the Fund's total portfolio. Following further discussion with the consultant, they arrive at a consensus shorter list of firms to be interviewed.

Both staff and the consultant interview candidates. Typically, a team of four senior staffers from the Fund (including the CIO and the specialist in the asset class in question) participate in these interviews. This collaboration allows staff to benefit from the consultant's insights into managers. Staff and the consultant discuss the interviews and any remaining questions, and then reach a consensus on a "finalist" to present to the Board.

The consultant prepares a report on the finalist for review by the Board. These reports include detailed information on investment returns achieved by each candidate, risks incurred, measures of manager style, measures of manager skill, as well as background information on the organization. It is our understanding that the Board discusses the report and the recommendation, and it ratifies the decision made by staff and the consultant. Board members ask questions during the discussion of the consultant's report, and direct inquiries to staff and the consultant following the presentations.

The Board reports that it is generally satisfied with the work of the staff and the consultant regarding manager selection and due diligence. We note one caveat, however: a few Board members expressed the desire for the consultant and staff to offer more choices in the manager selection process so that the Board could have the opportunity to participate more in the decision-making process. On the other hand, some Board members expressed that they were comfortable delegating the manager search process to staff and the consultant.

The results of past manager searches appear to confirm that the Fund's process works well. The Fund's manager roster is populated with investment managers that are well respected and generally successful in their investment disciplines.

The Fund also operates a "Developmental Program" for in-state, minority or women-owned investment management firms that was first established in 1994. At that time, the Board delegated to (the Alternatives Investment) staff the authority to select investment managers to be included in the program. The Fund's staff has sole responsibility for the evaluation of managers for this program; the Fund's general consultant is not involved in the due diligence procedures. Staff uses a variety of sources to identify firms for consideration, including the Wilshire Compass program. Staff screens firms on the criteria set for the program, reviews manager materials, interviews the most promising candidates, conducts site visits, and submits a report to the Fund's CIO. The CIO and the staff make the final decision on which managers to hire. The

program began with an allocation of 1% of total fund assets, but the Board increased that allocation to 1½% of total fund assets.

### 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.

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 PSERS Procedures for Monitoring External Equities and Fixed Income Managers**

***PSERS' Monitoring Procedures are Substantially Complete, but Staff is Spread Thin***

The Fund has a sophisticated investment program that involves the use of a large number of external public market investment managers. Most of the Fund's public market investment staff are responsible for directly managing equity and fixed income portfolios. The Fund devotes fewer staff and resources to monitoring external public market investment managers. This work falls primarily to the Fund's Chief Investment Officer, the Director of External Public Markets, Risk and Compliance, and the Compliance Officer. Staff reports that they monitor approximately 40 external public market investment managers who are responsible for 50 investment portfolios.

The Director of External Public Markets, Risk and Compliance is responsible for monitoring external and internal managers, selection of external public market investment managers, compliance reviews and proxy voting. In addition, he participates in decisions regarding asset allocation and the use of new asset classes. He is assisted by the Compliance Officer.

Staff relies on the general investment consultant to calculate investment manager rates of return (based on data provided by the Fund's custodian bank). The consultant and the custodian bank both calculate returns and are expected to reconcile their returns with those reported by the external public market investment managers on a monthly and quarterly basis. Staff also generates preliminary performance internally, which they can use to assist them in monitoring daily activity. The consultant's report covers beginning and ending market values for each account, cash flows, and period rates of return, and compares those returns to market indexes, however but it does not provide information routinely provided to other institutional investors such as measures of risk, portfolio characteristics and peer group rankings. Staff reports that the consultant provides a separate quarterly report (the "Investment Performance Analysis" book)

that contains additional information on risk such as portfolio characteristics related to average market capitalization of holdings, price/earnings ratios, price/book ratios, dividend yield and return on equity for the Fund's equity holdings. The performance analysis book also contains information on how managers rank in comparison to their peers.

Staff reports that they use an analytic system provided by the general investment consultant, Wilshire Compass, to load actual manager holdings and performance and to calculate common portfolio characteristics. This system is capable of calculating measures of risk, measuring portfolio characteristics, and comparing these risks and characteristics to those of an appropriate benchmark. Reports are generated quarterly.

***Compliance Reviews are not Performed as  
Frequently as They Should***

Relative to calculation of returns and measurements of risk, staff puts substantial time and resources into monitoring compliance by external public market investment managers. Different compliance checks are performed over the course of a year. Staff reports that the Fund receives a daily report on private securities (or securities that the Custodian cannot accurately identify) to determine whether portfolio holdings meet guideline requirements. Each quarter, external public market investment managers are required to submit letters confirming their compliance with fund guidelines. Staff seeks to do more thorough compliance reviews annually, but in actual practice, these reviews have been performed once every two years.

Staff identified the need to do more frequent compliance reviews. The quarterly certification letters submitted by external public market investment managers appear to be a means to compensate for the gap between the Fund's goals and how often the compliance reviews are accomplished. Mellon Bank provides the Fund with an automated system to perform compliance checks. Staff has made some use of this system, but they report that it is time-consuming to program the code required by the system and that staff has been unable to keep the



system updated. We understand that the code was last updated in August 2005 for those portfolios on which compliance reviews were performed.

The Fund's policy to make regular compliance checks of its external public market investment managers represents a best practice, but implementation difficulties have hampered this effort. Production of compliance reports should be streamlined, automated, or out-sourced in order to free up staff to investigate variances and to perform higher-level monitoring of manager performance and risks. Alternatively, the Fund should assign more staff to enable timely completion of compliance reviews.

***Periodic Qualitative Review of External Public Market  
Managers is Under-Resourced***

Staff attempts to make periodic, in-depth reviews of external public market investment managers, but finds it difficult to do so regularly. Given the small number of staff involved in monitoring external public market investment managers, the large number of managers employed by the Fund, and the other responsibilities assigned to these staffers, it is difficult for staff to perform the kind of qualitative investigation necessary. Staff reported that the external public market investment managers typically visit the System at least once per year but that staff does not have a requirement to perform annual on-site visits with the investment managers.

When staff determines that an external public market investment manager is performing below expectations, staff monitors the manager more frequently and more closely, in accordance with a short written set of procedures that the Fund applies to under-performing managers. These procedures include reference to "probation" for such managers and "Probation Reporting Requirements" that are sent to the managers.

The Fund should invest as much staff time, effort and resources in periodic review as it does in compliance checks. This need will become even more important as the Fund expands its use of sophisticated global macro strategy managers. These managers invest in multiple markets

and asset classes, using derivative instruments, in ways that can magnify both returns and risks. Return attribution and risk measurement will be more complicated and will require enhanced monitoring systems. Staff's time and energy would be better spent tracking closely the results of these strategies and evaluating the contribution these strategies make to total fund performance.

The use of derivative instruments such as futures, options, and swaps by the Fund's global macro managers creates risks that more conventional instruments do not entail. These risks may include, for example,

- Leverage;
- Counterparty risk (for over the counter transactions);
- Illiquidity (for over the counter transactions); and
- Operational, accounting and valuation challenges.

Along with the benefits of these strategies, the Fund must manage the implicit "costs" by strengthening the Fund's ability to monitor these risks.

Recommendations IB-1, IB-2, IB-3 and IB-4	PSERS Response
<i>The Board should work with staff and the general consultant to enhance the information the Board receives regarding the risks incurred by external investment managers.</i>	The Board agrees and will endeavor to institute this recommendation.
<i>PSERS should add staff to the process of conducting compliance checks of external equity and fixed income managers in order to increase the frequency of these checks.</i>	PSERS agrees. PSERS' Investment Compliance Division has hired one additional staff member, effective July 2006, to conduct compliance reviews of external and internal public market investment managers. This

Recommendations IB-1, IB-2, IB-3 and IB-4	PSERS Response
	personnel action should allow PSERS to meet its goals for compliance reviews.
<i>The Board should dedicate more staff and resources to allow for more regular in-depth qualitative review of the Fund's managers.</i>	PSERS agrees. PSERS' Investment Compliance Division has hired one additional staff member, effective July 2006, to conduct compliance reviews of external and internal public market investment managers. This personnel action will allow PSERS to dedicate more time to more regular qualitative reviews.
<i>The Fund should enhance its monitoring procedures to meet the specific challenges created by use of new global macro 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>	The Board agrees and will endeavor to institute this recommendation.

**c. Review of PSERS Monitoring of Internal Investment Managers**

It is common for large public funds to employ both external and internal managers to manage Fund assets. Because internal staff works more closely and intimately with executive staff and Board of the Fund, they are sometimes not evaluated in the same ways as external managers. However, best practices indicate that internal managers should be subject to the same monitoring procedures as external managers, and internal managers should be accountable to the Board in similar ways.

***PSERS Applies the Same Monitoring Procedures to Internal Managers as it Does External Managers***

PSERS' internal staff manages approximately \$15 billion in domestic and international equities and \$2 billion in fixed income assets. The Fund's general investment consultant (and custodian) is responsible for calculating investment rates of return for the internal managers. The Fund's compliance staff uses the Wilshire Compass system to evaluate the performance and

risks of portfolios managed by internal staff. They also perform compliance reviews of internal portfolios. The compliance staff seeks to review internal portfolios twice each year, but reports that in practice, it performs such reviews once each year.

Internal managers are required to provide quarterly certification that their portfolios are in compliance with Fund guidelines. Internal managers are not subject to any pre-trade compliance checks as part of the security trading procedures of the Fund.

**Use of Derivatives Requires Additional Monitoring**

The 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 by its investment managers. To the extent that the Fund allows its staff to purchase such securities directly, it needs to strengthen its credit analysis capabilities to evaluate counter party risk and its internal controls to prevent mistaken or unauthorized transactions. 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.<sup>72</sup>

Recommendations IB-5, IB-6 and IB-7	PSERS Response
<i>With respect to its internal investment managers, the Fund should enhance its monitoring procedures in the same was as for external investment managers.</i>	PSERS agrees. As noted in the report, however, PSERS has already instituted similar monitoring procedures for the internal public market investment managers as it has for the external public market investment managers.
<i>The Fund should enhance its trading systems to include automated pre-trade compliance checks of any securities purchased.</i>	PSERS agrees and will endeavor to institute this recommendation.

<sup>72</sup> Standard & Poor’s recently noted the growing use of derivatives and the need for investors to analyze more closely the risks such securities entail. See “Increasing Derivative Use by Corporate Issuers Calls for Closer Scrutiny”, November 9, 2005. A copy can be found at [http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/sp\\_article/ArticleTemplate&c=sp\\_article&cid=1130750632410&b=5](http://www2.standardandpoors.com/servlet/Satellite?pagename=sp/sp_article/ArticleTemplate&c=sp_article&cid=1130750632410&b=5)

Recommendations IB-5, IB-6 and IB-7	PSERS Response
<i>As the Fund increases its direct purchase of futures, options, swap contracts, or other derivative securities, it must develop stronger internal controls to minimize the potential for operational errors, unauthorized transactions, or miss-specified hedges that have harmed other institutional investors in currency and derivative markets.</i>	PSERS agrees and will endeavor to institute this recommendation.

### 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.

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.

#### **b. Review of PSERS' Investment Guidelines**

##### ***PSERS' Guidelines are Thorough but Could be More Tailored to Each Investment Manager***

PSERS has individualized guidelines for each sub-asset class and these guidelines are posted on their website. Each separate account manager does not have individualized guidelines prepared specifically for their portfolio, i.e., there is one set of guidelines for "Domestic Style-

Oriented Small Cap Equities” versus distinct guidelines for each small cap equity manager. However, we understand that most of the investment managers have “amendments” to the base guidelines (or Addendums) discussed below, which contain additional custom elements and to ensure that PSERS does not limit their investment opportunities. Monthly, a report of the approved amendments is provided to the Board and a full compilation of the amendments is available on the Board’s website. The standard Addendums are available on the public PSERS website. We understand that PSERS staff (the Director of External Public Markets, Risk & Compliance or the Compliance officer, with the approval of the CIO) prepares the guidelines, which are reviewed by the Consultant. We reviewed a representative sample of PSERS’ investment guidelines and discuss two below. In general, we found the guidelines for the various sub-asset classes to be very similar so our recommendations apply to all.

***Domestic Style-Oriented Small Cap Equities (“Addendum C”):*** The small cap equities guidelines contained most of the essential elements, including:

- Investment objectives and return requirements, including criteria for placing a manager under more intense scrutiny (commonly referred in the industry as placing a manager on a “watch list” or on “watch”);
- Fiduciary standard of care;
- Risk criteria, including: capital loss, credit or bankruptcy, liquidity and diversification (e.g., constraints on sector weightings versus the Russell 2000 benchmark);
- Certain characteristics such as capitalization;
- Maximum amount allowed in cash (7%);

- Prohibited securities, e.g., derivatives, private placements;
- Direction that all trades should be made through the Fund's trading desk, unless granted approval otherwise;
- Requirement to maintain Errors & Omissions coverage and a Fidelity Bond;
- Proxy direction (voted by the Board);
- Action required for breach of guidelines; and
- Communication and reporting requirement.

However, since these guidelines don't apply to one specific manager's product we believe they are overly general in certain areas, such as the exact style definition and other characteristic requirements versus their style benchmark (e.g., Price/Earnings ratio generally greater than or less than the index, depending on the manager's style). In addition, in Section II. Objectives and Goals, the guidelines state that returns will be measured on a three-year annualized rolling return basis, in addition to reviewing quarterly returns. We agree that it is not prudent to focus too much attention on very short-term results (e.g., one quarter), but it is advisable to consider multiple time periods when monitoring managers, e.g., one, three, five-year and since inception returns, even if "watch" status is determined by three-year rolling returns. We believe that it is best practice to have individual guidelines for each investment portfolio.

In addition, Section VI. Amendments and Review of the guidelines states "It is the Board's intention through the consultant and Investment Staff to review manager compliance with this document monthly." As discussed earlier in this section of our report, compliance monitoring is done, at most, quarterly through the manager's certification. Although we



understand that the onus is on the manager to report any guideline breaches immediately to the CIO and the Director of External Public Markets, Risk & Compliance.

**Treasury Inflation Protection Securities Portfolio (“Addendum L”):** The Treasury Inflation Protection Securities (TIPS) guidelines were very similar to the Domestic Style-Oriented Small Cap Equities guidelines and contained the same the essential elements listed above so we have the same general comments. We have the following additional comments on the TIPS guidelines:

- Appropriately, they include additional restrictions applicable to fixed income securities on maturity, duration, credit ratings and downgrades and different cash restrictions.
- Hedging is allowed, but given the fact that there are three TIPS portfolios with slightly different mandates and strategies, this provision is not applicable to all three. Managers are allowed to use options, forward contracts and futures.
- International securities are permitted, up to 20%, but again it is our understanding that only one TIPS portfolio is global in nature.

Recommendations IB-8 and IB-9	PSERS Response
<i>PSERS investment staff should consider creating one custom investment guideline document for every investment manager, rather than using the standard more general Addendums and customized amendments.</i>	PSERS will consider this recommendation. As noted, however, PSERS has standard investment guidelines that are customized, through amendments, to meet each manager’s investment process. This allows PSERS to maintain a standard policy statement that lays the foundation for each mandate that can then be tailored for each manager’s specific mandate.

Recommendations IB-8 and IB-9	PSERS Response
<i>The Board should reconsider its requirements for guideline monitoring and work with staff to come up with a reasonable solution.</i>	The Board agrees. PSERS' Investment Compliance Division has hired one additional staff member, effective July 2006, to conduct compliance reviews of external and internal public market investment managers. This personnel action should allow PSERS to meet its goals for compliance reviews.

#### 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, 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. Valuation of both asset classes is less precise because the investments are not valued by public markets. 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 PSERS Procedures**

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

Private equity and real estate assets of the Fund are supervised by the Director of Alternative Investments. He and his staff of seven are assisted by two specialist consultants, one for real estate and one for other alternatives (private equity, venture capital, and private debt). Both consultants provide the Fund with a full complement of specialty consulting services (according to the demands of the asset class), and both are deeply involved in the due diligence process. Both 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. PSERS hired its current real estate consultant (Courtland) in mid-2005 and the firm has yet to begin providing services to the Fund.<sup>73</sup> The private equity consultant has served the Fund for three years. Its reports 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

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<sup>73</sup> Russell was the prior real estate consultant and they exited this line of business.

Fund, and to prepare materials to brief the Board on the managers and funds. Staff and the consultants appear to strive to reach consensus on any decisions made or recommendations forwarded to the Board. The consultants were described as “extensions” of the staff. We believe that 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 does not dampen any reasonable difference of opinion between staff and the consultants about strategy, managers or performance.

It is our understanding that staff attempts to take advisory board seats on every investment in the Fund’s private equity and real estate portfolios. Staff reported at the time of our on-site work that the Fund invests in approximately 150 partnerships; hence advisory board work involves a substantial portion of staff’s time. Participation on advisory boards clearly offers significant benefits in terms of information on manager practices, market conditions and staff development. However, the “opportunity costs” of these efforts are high. The Board and staff should discuss whether it is beneficial to the Fund to participate in as many advisory boards, and whether or not some portion of staff time should be deployed elsewhere. Alternatively, the Board should consider staff’s request for more personnel for this function.<sup>74</sup>

Recommendations IB-10 and IB-11	PSERS Response
<i>With respect to private equity and real estate, the Fund’s methods for monitoring managers and investments are sound and should be maintained.</i>	The Board and PSERS agree and are pleased that IFS has determined that PSERS is complying with best practices in this area.
<i>The Board and staff should consider whether it should be the Fund’s practice to participate on as many advisory boards as possible, or whether staff should prioritize the time it invests in advisory board work.</i>	The Board will consider this recommendation. PSERS understands the point that IFS is making; however, staff uses the time on advisory boards for two important purposes. First, oversight of existing investments and second, as due diligence on the general partnerships which is then used to assist in future

<sup>74</sup> We understand that, as of the writing of this report, PSERS is in the process of hiring an additional investment professional in the Alternative Investment area to help with the Advisory Board workload.

Recommendations IB-10 and IB-11	PSERS Response
	decisions on investment in the general partner's next fund. In short, at this time PSERS finds the opportunity costs higher by not participating on the advisory boards. Notwithstanding, PSERS is in the process of hiring one additional staff member in the Alternative Investment area that will help with the Advisory Board workload.

*Please see DAG's response at Exhibit F 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 participants and beneficiaries.

***PSERS Does Not have Access to Legal Counsel  
with an Unconflicted Loyalty to the Interest of PSERS***

The PSERS Board does not hire or fire its legal counsel, and does not set their compensation. PSERS receives legal advice from a staff consisting of a Chief Counsel, two Deputy Counsel and three Assistant Counsel, 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, evaluating<sup>75</sup> and setting the compensation of all Counsel and has the power to fire them. 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 either selects or approves the selection of the law firm.

The fact that PSERS' legal counsel is an employee of and under the control of the Commonwealth's executive branch creates an inherent structural conflict of interest. The Governor's control, through the General Counsel, over PSERS' attorney is inconsistent with the

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<sup>75</sup> 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 PSERS 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." This new system had not yet been implemented at the time of our information gathering.

Board's purported status as an independent<sup>76</sup> body with a membership representative of multiple stakeholders, all of whom, unlike the Governor, have a fiduciary responsibility to the PSERS membership. In reality, the interests of the Governor are not necessarily always aligned with the interests of PSERS and its Board. That is not peculiar to PSERS. It has become a recognized best practice for a public retirement system to have the authority to engage its own legal counsel.<sup>77</sup> This structural problem is mitigated, but not eliminated, by the current PSERS 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.<sup>78</sup> 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 PSERS at the moment. Our focus is on identifying structural attributes of the System that create risks or 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 process that will mitigate those risks and enhance the System's 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.

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<sup>76</sup> Although Retirement Code Sec. 8501(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.

<sup>77</sup> 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 two states, Maryland and Wyoming, have adopted UMPERSA, more 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.

<sup>78</sup> IFS recognizes that, as PSERS' 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 69. 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.



Table I-C-1 below presents a review of the authority of 22 other public fund boards, outside the State of Pennsylvania, 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 public fund boards is designated as the legal advisor (or some comparable term), whether the board has its 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 (59%) has their own independent legal counsel (or has the authority to hire counsel). Even in the case where the attorney general is designated as the legal advisor to the Board, seven of the funds (32%) have their own independent in-house counsel (i.e., not under the control of an external entity). Nevertheless, 50% of the peer group boards do not have independent in-house legal counsel where the attorney general is the designated legal counsel. 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 expedite the time require to do through the required approval process). Although this is a common practice, it is not consistent with best practices because it created an inherent conflict and does not foster effectiveness and efficiency of the pension fund's operations.

<b>Table I-C-1 – Board Authority to Select Legal Counsel</b>			
<b>Pension Board</b>	<b>Attorney General is Designated Legal Advisor to the Board</b>	<b>Board has its own independent in-house legal counsel</b>	<b>Attorney General must approve Board use of external counsel</b>
State Employees Retirement System of PA	Yes	No	Yes
Iowa PERS	No	Yes	No <sup>79</sup>
LACERA (has two boards – BOR & BOI)	Yes <sup>80</sup>	Yes	No <sup>81</sup>

<sup>79</sup> The CEO approves the use of external counsel

<sup>80</sup> 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

<b>Table I-C-1 – Board Authority to Select Legal Counsel</b>			
<b>Pension Board</b>	<b>Attorney General is Designated Legal Advisor to the Board</b>	<b>Board has its own independent in-house legal counsel</b>	<b>Attorney General must approve Board use of external counsel</b>
Md. State Retirement and Pension System	Yes <sup>82</sup>	Yes	Yes
Mass PRIM	No	Not currently <sup>83</sup>	No <sup>84</sup>
Minnesota State Board of Investment	Yes	No	Yes
Mississippi PERS	Yes	No <sup>85</sup>	Yes
Missouri Public School	No <sup>86</sup>	Yes	No
MOSERS	No	Yes <sup>87</sup>	No
Nevada Public Employees	Yes	No	Yes
Virginia Retirement System	Yes	No	Yes
<i>State of Wisconsin Investment Board</i>	No	Yes <sup>88</sup>	Yes
<i>Wash. State Investment Board.</i>	Yes <sup>89</sup>	No	Yes <sup>90</sup>
<b>Public School Employees Retirement System of PA</b>	<b>Yes</b>	<b>No</b>	<b>Yes</b>
Arizona State Retirement System	Yes	No	Yes
California State Teachers Retirement System	No	Yes <sup>91</sup>	No
<i>Colorado PERA</i>	Yes <sup>92</sup>	Yes	No
State of Michigan Investment Board	Yes <sup>93</sup>	No	Yes
New York State Teachers Retirement System	Yes	Yes	Yes
North Carolina Retirement System	Yes <sup>94</sup>	No	Yes
Ohio Public Employees Retirement System	Yes	Yes <sup>95</sup>	Yes
State Teachers Retirement System of Ohio	Yes	Yes	Yes
Oregon Public Employees Retirement Fund	Yes	No	Yes

<sup>81</sup> Pursuant to §31529.1 and §31529.5 of the County Employees Retirement Law, the board is authorized to retain legal counsel.

<sup>82</sup> §21-107 - The Attorney General is the legal adviser of the Board of Trustees.

<sup>83</sup> The Board is authorized to employ legal counsel pursuant Chapter 32§23 of the Massachusetts General Laws and the Authorizing Trust.

<sup>84</sup> However, pursuant to Section 11.1, the Trustees shall give notice to the Attorney General of the Commonwealth of any legal proceedings.

<sup>85</sup> Special Assistant General Attorney serves as legal counsel.

<sup>86</sup> 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.

<sup>87</sup> §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.

<sup>88</sup> §25-156(3) of the 2005 Wisconsin Statutes provides that “the members of the board shall appoint ... chief legal counsel...”

<sup>89</sup> A.G. serves as legal counsel to state agencies, boards and commissions

<sup>90</sup> Per staff, must obtain AG’s approval of any outside counsel who is paid for with trust fund assets.

<sup>91</sup> In-house general counsel and external fiduciary counsel.

<sup>92</sup> §24-51-216 Colorado Revised Statute – Attorney General is legal advisor to the Board

<sup>93</sup> The investment function of Michigan state retirement systems is controlled by the treasurer, whose designated legal advisor is the AG.

<sup>94</sup> 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.

<sup>95</sup> In-house legal counsel and external fiduciary counsel.

<b>Table I-C-1 – Board Authority to Select Legal Counsel</b>			
<b>Pension Board</b>	<b>Attorney General is Designated Legal Advisor to the Board</b>	<b>Board has its own independent in-house legal counsel</b>	<b>Attorney General must approve Board use of external counsel</b>
Texas Teachers Retirement System	Yes <sup>96</sup>	Yes	Yes

IFS recognizes that legislation would be required for the PSERS 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 PSERS 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* an issue fraught with conflict arises will assure that the interests of PSERS 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.

<sup>96</sup> § 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	PSERS 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 PSERS attorney's authority, as well as the relationship between the PSERS attorney and the Commonwealth General Counsel.</i></p>	<p>The Board believes this is a matter for the General Assembly since it requires legislative action. It should be noted, however, that over the years the issue of independent counsel for PSERS and SERS has been raised at various times by legislative members of both parties. Notwithstanding, the General Assembly has not taken any action to change the legal representation of either PSERS or SERS. Regardless of any legislative action that may or may not be taken, the Board believes that the legal services rendered to the System and the Board should be rendered by a unified legal office, whether the General Assembly determines to create an independent legal office, or, as it currently stands, is appointed by the Office of General Counsel. To do otherwise would lead to duplication of services, additional costs and/or unnecessary conflicts in advice and opinions. Finally the Board is unaware of any mechanism or process to ensure or obtain "a binding, permanent directive from the General Counsel" on this or any other administrative matter.</p>
<p><i>So long as a Chief Counsel appointed by and serving at the pleasure of the Commonwealth's General Counsel remains the PSERS attorney of record, the Board and the General Counsel should negotiate with the General Counsel 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, PSERS and/or its Board may engage its own legal counsel, and (ii) to select and compensate such separate counsel.</i></p>	<p>The Board will consider this recommendation. In doing so, however, the Board notes that PSERS has had no difficulty obtaining, through the Office of General Counsel (OGC), qualified outside counsel, either in Pennsylvania or elsewhere, to handle PSERS specialized legal affairs. Similarly, there has been no recent history (fifteen plus years) in which counsel may have been needed because of a potential conflict of interest between PSERS and the Governor's Office. Therefore the Board questions whether a Memorandum of Understanding (MOU), is</p>

Recommendations IC-1 and IC-2	PSERS Response
	necessary on that issue, especially since to negotiate such a memorandum may abrade the current good relationships between PSERS and OGC, for no reason. Finally, as noted above, such a MOU would not be permanent and binding upon the OGC and more than likely it will not cover the one sensitive issue that may give rise to a conflict of interest in the future.

***PSERS' Chief Counsel Provides Capable Legal Support to the Investment Function***

One Deputy Counsel and two Assistant Counsel have principal responsibility for investment-related issues. That specialization enables the Board to retain in-house the legal work for virtually all investment-related matters, including private equity issues. The Chief Counsel has developed standardized forms of agreements for investment managers and private equity transactions to facilitate the process of negotiating and consummating transactions which the Board has authorized.

In the case of private equity, Counsel worked with the Investment Office Staff to create a form of Letter of Understanding setting forth the basic terms PSERS requires that a prospective manager must accept before the PSERS staff engages in due diligence with the manager. The Letter of Understanding addresses issues such as the general partner's commitment, fees, indemnification, withdrawal rights and fund governance, consistent with the enumeration of issues in the Private Investment and Venture Capital Policy appearing as Addendum X to the PSERS Investment Policy Statement. The term sheet also requires, consistent with a Board resolution enacted in April, 2005, that the partnership "not knowingly make investments in portfolio companies that outsource or privatize the jobs of active members of [PSERS]." It is too soon to know whether this provision will impair PSERS' ability to find attractive private equity investments by deterring the sponsors of such investments from presenting proposals.

When the Board approves a particular private equity or venture capital investment, the resolution appearing in the minutes typically states, “The final terms and conditions of the investment must be satisfactory to the Investment Office, the Office of Chief Counsel, and the Executive Director.” The Chief Counsel’s office works with the Investment Office in negotiating with particular general partners of limited partnerships, and it is typically left to the Investment Office to make business decisions about particular issues and to decide whether further Board involvement is necessary on a particular point. There are no stated criteria for identifying the modifications that are sufficiently material to require notice to or approval from the Board, or a process for informing or obtaining input from the Board with respect to specific transactions. This is not unusual. Managing such issues requires balancing between assuring that particular investment transactions reflect the Board’s investment policies and decisions in all material respects and involving the Board in inappropriate micromanagement of the negotiation of specific transactions. None of the Board, the Chief Counsel, the Investment Office or the Executive Director expressed any concerns that the process of finalizing contracts was not working well due to this issue, so IFS has no recommendations in this area.

### ***General Counsel and Attorney General Oversight of Contracting Adds Little Value***

A different 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 legal (as opposed to business) matters, and sign off on, all agreements PSERS enters into.<sup>97</sup> The increased use of standardized forms of agreement, pre-approved by the General Counsel and the Attorney General as permitted by the Commonwealth Attorneys Act<sup>98</sup>, has improved the efficiency of the process. In addition, PSERS’ 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”

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<sup>97</sup> 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.

<sup>98</sup> Ibid.

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 PSERS' agreements, no substantive positive contribution from the General Counsel or Attorney General to PSERS' investment program as a result of their review of specific contracts has been identified, and some still see their involvement as at least potentially burdensome. 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.<sup>99</sup> We would expect that relieving PSERS of the need for General Counsel and Attorney General approval of contracts could be accomplished in the course of establishing a legal department within PSERS responsible exclusively to PSERS and the Board, as recommended above.

Recommendation IC-3	PSERS Response
<p><i>The Board should support the adoption of legislation amending the Commonwealth Attorneys Act to exempt PSERS 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 PSERS Chief Counsel should continue and expand, if possible, its practice of developing 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.</i></p>	<p>The Board believes this is a matter for the General Assembly since it requires legislative action. With respect to the practice of developing form contracts pre-approved by the General Counsel and the Attorney General, PSERS Office of Chief Counsel has, in fact, developed form contracts for all contracts that are possible to be pre-approved. The principal agreements still requiring formal approval are the various documents ancillary to PSERS investments in limited partnerships. Since these documents are prepared by the general partners and are negotiated individually, they do not lend themselves to pre-approval.</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

<sup>99</sup> 71 P.S. Sec. 732-402(6).

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)<sup>100</sup> 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).<sup>101</sup> 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 PSERS Retirement Code Articulates an  
Appropriate Standard of Fiduciary Responsibility***

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<sup>100</sup> 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.

<sup>101</sup> UMPERSA Sec. 7. The official Comment to UMPERSA Sec. 7 observes that the ERISA standard has been adopted by "many states."



The Retirement Code explicitly imposes fiduciary status on “[t]he members of the Board, employees of the Board, and agents thereof.”<sup>102</sup> The Retirement Code requires that the Board manage and invest the PSERS funds:

*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 fund, considering the probable income to be derived therefrom as well as the probable safety of their capital.*<sup>103</sup>

This formulation of a standard of care, which can be described accurately as a “prudent investor” standard,<sup>104</sup> closely tracks the widely accepted standard of prudence articulated in ERISA and UMPERSA, two widely accepted sources of appropriate standards for pension fund fiduciaries.<sup>105</sup> One widely cited federal appeals court opinion interpreting ERISA described the ERISA fiduciary standard as “the highest known to law.”<sup>106</sup> 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

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<sup>102</sup> Retirement Code Sec. 8521(e).

<sup>103</sup> *Id.*, Sec. 8521(a).

<sup>104</sup> 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.

<sup>105</sup> 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.

<sup>106</sup> *Donovan v. Bierwirth*, 680 F.2d 263, 271n.8 (2d Cir.), cert. denied, 459 U.S. 1069 (1982).

investment horizon which UMPERSA articulates and are meaningful elements of prudent investment decision-making.

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,”<sup>107</sup> 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 the PSERS assets similar to the duty of diversification articulated in ERISA and UMPERSA.<sup>108</sup> Nonetheless, it is apparent from the PSERS Investment Policy Statement that the PSERS Board has acted consistent with that duty.<sup>109</sup>

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” which impose percentage limits and, in some cases, outright bans on particular categories of investments, without reference to their fitness under the fiduciary standards. This approach is consistent with both ERISA 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.<sup>110</sup> 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.

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<sup>107</sup> *Id.*, Sec. 8521(e).

<sup>108</sup> ERISA Sec. 404(a)(1)(C); UMPERSA Sec. 8(a)(2).

<sup>109</sup> The Investment Policy Statement provides, in its discussion of Asset Allocation, “The purpose of the Board’s long-term asset allocation is to achieve diversification, or a combination of expected return and risk, that is consistent in meeting the near and long-term financial needs and objectives of the Fund.”

<sup>110</sup> UMPERSA Sec. 8(a)(4).

8521(e), they stand in the same “fiduciary relationship” to the PSERS members as the Board members do. However, Section 8521(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 investor standard creates a possible ambiguity on this point, which is crucial in view of the large number of PSERS Board members authorized to act through designees and the large number of designees some Board members name. It would therefore be advisable for there to be a clear and formal statement holding designees to the same standard of prudence which applies to the Board members. Similarly, it would be appropriate to require designees to take the same form of oath as the Board members for whom they act.<sup>111</sup> An appropriate procedure to accomplish that result would be an amendment to the Bylaw provisions which authorize the appointment of designees.

Recommendations IC-4 and IC-5	PSERS 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>	The Board agrees and will endeavor to institute the recommendation. In doing so, the Board notes that all Board member designees are well aware that they are subject to the same fiduciary standards as the Board members they represent.
<i>The Board should amend the Bylaws to require designees to take the same oath as Board members.</i>	Although not legally required, the Board will consider this recommendation.

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. While 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 PSERS Board members from similar liability, the fact is that the doctrine does not immunize the Board or its members from exposure to legal expense associated with asserting that defense if sued and, possibly, defending the substantive claims. PSERS has adopted an indemnification policy which

<sup>111</sup> Retirement Code Sec. 8501(c) requires each Board member to take an oath “that he will, so far as it devolves upon him, diligently and honestly administer the affairs of said board and that he will not knowingly violate or willfully permit to be violated any of the provisions of law applicable to {PSERS}.” Section 2.5 of the Bylaws relieves designees of the requirement to take that oath.

covers those expenses, which can be considerable. Accordingly, it is in the interest of the PSERS Board members, as well as PSERS itself, for Board members to obtain the training necessary for them to meet their challenging fiduciary responsibilities. This is because while it is 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.<sup>112</sup>

### 3. Legal Provisions that Constrain Performance

As indicated above, fiduciary standard 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, the independence of this section is an important corollary of the fiduciary obligations [trustees must comply with].*

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<sup>112</sup> D. Levin, T. Ferrera, ERISA Fiduciary Answer Book, Sec. Q 4:25 at 4-32-33 (4<sup>th</sup> Ed., Aspen Publishers, Inc. 2001).

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 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 PSERS 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 PSERS 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 PSERS Board, as to what level of benefit liability to assume and how to pay for it.<sup>113</sup> 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 inconsistent with the Trustees’ fiduciary duties.

***PSERS’ 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 the PSERS assets. However, certain provisions of law that apply to PSERS operations may have that effect, and certainly impair the autonomy of PSERS and its Board. As set forth below, we recommend that PSERS be granted

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<sup>113</sup> 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.

autonomy that it currently does not have to select its own legal counsel (as set forth above) and 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 PSERS be freed from appropriate oversight. We do not recommend modifying the public disclosure and open meeting law requirements as they apply to PSERS. Nor do we advocate changing any of the several public reporting and disclosure requirements applicable to PSERS.<sup>114</sup> 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.<sup>115</sup>

#### **a. Budget Process**

Retirement Code Sec. 8502(c) provides that PSERS' administrative expenses be paid from the investment earnings of the funds, not from the Commonwealth's general treasury. In addition, the PSERS Board is, as discussed above, subject to a rigorous standard of fiduciary responsibility with respect to the PSERS funds. These characteristics render PSERS different from government agencies whose budgets are paid from appropriations, and are properly subject to political control. Nonetheless, the Retirement Code requires that PSERS' 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. Thus, PSERS' administrative budget is subject to the same political process as the rest of the Commonwealth's budget approved by the General Assembly, even though PSERS provides the funds to pay the expenses.

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<sup>114</sup> See, e.g., Retirement Code Secs. 8502(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), (n) (requiring publication and distribution to Governor and "the head of each department" an annual financial statement ) and (o) (requiring an annual audit of the System by an independent CPA).

<sup>115</sup> IFS acknowledges that our recommendations to grant PSERS 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 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 PSERS Board and staff have the capacity to meet those challenges

PSERS' staff prepares a budget for consideration by the Board after obtaining guidance from the Governor's office about the overall increase that is likely to be acceptable. Once the Board approves the budget, it is submitted to the Governor's Office of the Budget, which frequently reduces it before submitting it to the General Assembly to conform to the Governor's overall budget policies. After approval by the General Assembly, staff adjusts the particular line items within the budget to conform to the limits which emerged from the appropriation process described above, and the modified budget is submitted to the Board.

Subjecting PSERS' administrative budget to this process renders the PSERS Board subject to political constraints completely unrelated to the needs of the System. It also effectively treats PSERS 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 PSERS. The presence of legislators appointed by legislative leaders on the PSERS Board can be an effective counterweight since they are in a position to advocate in the legislature on behalf of PSERS' interests. The impact of the budget process on the PSERS investment functions is not particularly mitigated by the fact that the costs of external investment management are outside the budget process in view of the extensive internal management of PSERS' assets. The Board's ability to invest in staff (including investment staff), technology and other resources is subject to constraints based on considerations external to PSERS. So long as the Board's decisions regarding expenses to be paid from PSERS' 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 PSERS. See UMPERSA Secs. 5(a) and (b).<sup>116</sup>

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<sup>116</sup> 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-6	PSERS Response
<p><i>The Board should support legislation to grant the Board autonomy in establishing its administrative budget to be paid from PSERS 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 PSERS' members.</i></p>	<p>The Board believes this is a matter for the General Assembly since it requires legislative action. As with the other "independence recommendations" the Board is well aware of the pros and cons of this issue. Generally speaking, however, over the years the Board has had adequate financial resources to fulfill its mission, particularly with respect to its investment functions. In fact, the Board is particularly pleased with the current Governor's Office of the Budget support for PSERS' annual administrative budget requests.</p>

**b. Selection of Custodian**

The Retirement Code provides, "The State Treasurer shall be the custodian of the fund."<sup>117</sup> In practice this not uncommon statutory authority has resulted in the State Treasurer selecting and contracting with the custody bank on behalf of PSERS 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. PSERS 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. PSERS 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 PSERS.

The custody function involves much more than the safekeeping and accounting for PSERS 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

<sup>117</sup> Retirement Code Sec. 8521(c).



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 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 PSERS' size could obtain a contract with a fee as low as PSERS' 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 PSERS Board, which is bound to a rigorous fiduciary standard of care and a duty of loyalty to the PSERS members. A legal and operational structure that provides to both the PSERS and SERS 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 PSERS and SERS 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-7	PSERS 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 PSERS. 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, the Board and the State Treasurer should collaborate in establishing a mechanism whereby the PSERS 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"> <li>• <i>the review of the performance of the custodian,</i></li> <li>• <i>possible enhancements to the services provided by the custodian,</i></li> <li>• <i>any decision to replace the custodian,</i></li> <li>• <i>development of the scope of services to be provided by any new custodian and</i></li> <li>• <i>the selection of a new custodian</i></li> </ul>	<p>The Board believes this is a matter for the General Assembly since it requires legislative action. Notwithstanding, over the years there has been steady progress in enhancing PSERS input to the State Treasurer's selection process for the custodian bank, including the opportunity for PSERS to request and receive, as part of the contract process, PSERS specific requirements from the custodian bank, e.g., specialized reports. Indeed, PSERS' relationship with the current State Treasurer has been excellent.</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 PSERS.

One example is the area of information technology. The Office of Technology within the Governor's Office of Administration sets overall information technology standards for all state agencies, which PSERS must adhere to regardless of their suitability to PSERS' mission, absent a waiver granted by the Office of Technology at its discretion. The Office of Technology can also veto technology expenditures approved by the Board, and the Board does not even see the Technology Strategic Plan prepared by PSERS staff (although it is part of the business plan

developed by staff to be consistent with the Board-approved budget request); instead it is sent to the Office of Technology for approval.

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. Under what was described to us as a new "strategic sourcing initiative," the Commonwealth's Department of General Services, another gubernatorial agency, can decide to take over the administration of PSERS' requests for proposals ("RFPs") rather than allow PSERS to administer them. To date the Department of General Services has granted all four of PSERS' requests for permission to administer its RFPs. After PSERS receives approval to administer an RFP, the RFP is submitted to Central Services Comptroller's Office and the Bureau of Minority and Women Business Opportunity for their review before issuance. The delays caused by these external levels of approval and review have been accepted by PSERS as part of "doing business," and while some RFPs have drawn fewer bids than anticipated, PSERS staff does not believe that any meaningful business opportunities have been lost due to the process.

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 PSERS 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 in the PSERS complement of salaried employees, and the Office of Administration must approve increases in the complement of hourly employees (typically temporary employees). The Bureau of State Employment, a part of the Office of Administration, can decide whether to permit PSERS to recruit investment professionals from

outside the Commonwealth workforce. And, 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 PSERS, however. The Board has approved compensation increases for investment staff in the face of a general pay freeze, and has developed the PSERS Incentive Plan.

When the involvement with procurement and personnel practices is combined with the influence of the Governor’s office over PSERS through its control of PSERS’ Chief Counsel and PSERS’ budget process, it is only natural that more than one key PSERS staff thinks of PSERS as “under the Governor’s jurisdiction” rather than as an autonomous board. That said, we are advised that the Governor’s Office of Administration provides PSERS with valuable technical assistance on personnel policies, information technology and financial accounting issues which enhance the efficiency of PSERS’ operations. IFS believes that PSERS should be able to retain access to those services without being required to submit to all the oversight which the Office of Administration exercises over ordinary agencies which do not have the unique characteristics of a retirement system as discussed above.

Recommendation IC-8	PSERS Response
<p><i>The Board should support legislation to grant the Board autonomy in procurement and personnel policies, provided that such legislation (i) 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 PSERS members, and (ii) that the resources of the Office of Administration remain available to PSERS on request.</i></p>	<p>The Board believes this is a matter for the General Assembly since it requires legislative action. As with the other “independence recommendations” the Board is well aware of the pros and cons of this issue. In this case, however, the Board already has independent compensation and classification authority for its investment professionals. Further, PSERS investment contracts are outside the scope of the Commonwealth’s procurement law. While PSERS investment consulting contracts are subject to the Commonwealth’s procurement rules, PSERS has not experienced any difficulties in complying with those rules.</p>

#### 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 PSERS' Board Could be Enhanced***

Article VI of the Bylaws imposes two layers of standards of ethical conduct. First, the Board and its members 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.<sup>118</sup> In addition, legislative members of the Board are subject to the Legislative Code of Ethics.<sup>119</sup> Finally, the Board has adopted a Travel and Education Policy governing conduct by Board members.

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<sup>118</sup> 4 Pa. Code §§ 7.151-159, 161-164, 171-179.

<sup>119</sup> 46 Pa. Code §§ 143.1 *et seq.*

Many of these provisions (i.e., the Ethics Act, the Governor’s Code of Conduct, the Legislative Code and the Travel Policy) 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.

Recommendation IC-9	PSERS Response
<p><i>The Board should review on a comparative basis the Governor’s Code of Conduct, the Legislative Code 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>The Board will consider this recommendation. In doing so, the Board and its members are well aware of their need to maintain the highest ethical and fiduciary standards as they serve the members of the System. This includes not only avoidance of actual impropriety, but also the perception of impropriety. It also includes strict adherence to the existing statutory and/or regulatory requirements applicable to the Board in this area.</p>

The substantive rules and reporting requirements imposed by the Ethics Act and the Governor’s Code of Conduct are consistent with the types of rules imposed by the ethics laws of other jurisdictions. The Ethics Code 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 Code, 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 Code, and, in IFS' view, are more appropriate. Tying the gift restriction to the existence of an "understanding," as the Ethics Code 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.

### ***The PSERS Travel Policy Lacks Certain Appropriate Controls and Limits***

IFS reviewed the travel and expense reimbursement policies applicable to Board members. The Board has adopted a Travel and Education Policy (the "Travel Policy"), which incorporates by reference the Governor's Office's Management Directive 230.10 on Travel and Subsistence Allowances (the "Management Directive"). The Travel Policy describes the types of events that PSERS Board members may attend at PSERS' expense, while the Management Directive contains extensive procedural rules for obtaining reimbursement of travel expenses.

The Travel Policy imposes fewer controls and more lenient limitations than the comparable policies of other statewide retirement systems.<sup>120</sup> Most other systems require prior approval by either the full board or its chair of travel for educational conferences. In some cases, prior approval is not required for one trip per year to an event such as a meeting sponsored by the National Council on Teacher Retirement, and travel is restricted to just a couple of meetings each year. The PSERS Travel and Education Policy, by contrast, provides that Board members are each "entitled to reimbursement by PSERS" for up to *five* meetings per year, three of which may be to events on a list of Preapproved Educational/Industry Meetings and two of which are on a separate list of Preapproved Annual Educational/Industry Meetings. The Board Chair and Finance Committee Chair are not bound by either of these limits. Board members do not need

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<sup>120</sup> The comparison articulated in the text is based upon data in the 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>

pre-approval at all, except that approval of the Board Chair and Secretary is required for receiving reimbursement for more than these five events, or for attending an event outside the United States.

Permitting each Board member to attend up to five educational meetings outside Pennsylvania each year, without any prior approval from the Board, seems excessive, notwithstanding that the Management Directive imposes appropriate controls and limits on reimbursement. IFS agrees with the statement in the final “Whereas” clause of the Board’s Travel Policy that Board members have an obligation “to be informed on issues and topics that may impact PSERS, which may include attendance at educational opportunities and interaction with other governmental pension plans.” However, Board members do not need to attend a meeting every ten weeks each year to fulfill that obligation. In addition, we question the prudence of a policy permitting the expenses associated with that much travel, which could amount to the cost for 75 meetings each year if every Board member attended every meeting to which he or she was “entitled.”

We acknowledge that the organizations listed on the Travel Policy’s exhibits whose events are pre-approved are all reputable organizations that conduct educational programs relevant to Board members’ responsibilities. Some of them, however, are financial services companies whose clients include public pension funds such as PSERS and whose events could inappropriately combine valuable trustee education with marketing of financial services. In this regard, we note that Section 6.3 of the Bylaws permits Board members to accept “food, refreshments, and/or recreational opportunities which are included as part of an educational conference or other officially approved meeting for which an inclusive registration fee is charged. . . regardless of whether the sponsorship of such conference or meeting may include, directly or indirectly, current or prospective State consultants. . . .” The Management Directive does not enumerate categories of expenses for which reimbursement is not available, other than a ban on reimbursement for alcoholic beverages.



Recommendation IC-10	PSERS Response
<p><i>The Board should review the Travel Policy and consider modifying it as follows:</i></p> <ul style="list-style-type: none"> <li>• <i>Require pre-approval by the Board or the Board Chair for reimbursement for attendance at any educational program.</i></li> <li>• <i>Require approval by the Board for reimbursement for attendance at more than two educational conferences outside the Commonwealth in a year by any one Board member.</i></li> <li>• <i>Review the lists of pre-approved events to assure they do not include events which present an appearance of inappropriate marketing of financial services, as opposed to purely educational functions.</i></li> <li>• <i>Supplement the Management Directive by enumerating categories of expenses for which reimbursement is not available.</i></li> </ul>	<p>The Board will consider this recommendation. Indeed, the Board has already begun addressing this issue. PSERS' Policy Review Agency Committee, which consists of staff and a number of Board members, is in the process of reviewing and, when appropriate, revising all of PSERS policies, including the Board's current Travel and Education Policy. At present, it is anticipated that the Board will consider a revised Board Education Policy before the end of this year.</p>

## 5. Pay to Play

### ***The PSERS Board Should Enhance its Proactive Approach to "Pay to Play" Issues***

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 PSERS can make political contributions to those who have the ability to serve on or to name those who serve on the PSERS Board, a practice known as "pay to play." A majority of the PSERS Board consists of either elected officials or persons appointed by elected officials (and, in the case of the legislative members, elected officials appointed by other elected officials). While Pennsylvania law requires candidates for public office to file public disclosure of campaign contributions, Section 6.3 of the Bylaws goes further by providing:

- Board members may not solicit political contributions from current or prospective “state consultants” (i.e., contractors who provide professional or advisory services to Commonwealth agencies, such as investment managers and consultants).
- Board members may not make other solicitations from current or prospective “state consultants . . . under circumstances which the recipient of such a solicitation could regard as coercive or which in any other way could raise a legitimate question about the member’s ability to fairly, impartially and prudently perform his or her duties on the Board.”

These provisions are a good start at addressing the pay to play issue. We note, however, that while they apply to Board members, they do not apply to either the Governor or to the legislative leaders who appoint Board members. This issue is addressed to some extent by the provisions of PSERS’ standard contracts with its investment managers and other providers of investment-related services, which require that the contractor not only acknowledge its duty to file reports of its campaign contributions but also to provide copies of such reports directly to the PSERS Executive Director.<sup>121</sup> In addition, the Commonwealth’s Standard Contract Terms and Conditions bar contractors from giving a “gratuity” to any Commonwealth officer or employee, although it is unclear whether that bar applies to political contributions to a candidate’s political committee. It is also unclear whether there is a process in place for monitoring candidates’ financial disclosure reports to confirm compliance with the provisions of the Bylaws and contract terms. Finally, it is not clear whether the Bylaws provisions apply to contributions to the campaigns of candidates for Board positions elected by PSERS’ membership.

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<sup>121</sup> The statute referenced in the contract 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. . . .” We are advised that PSERS takes the position that its investment management contracts and the limited partnership agreements it enters into are “non-bid contracts” subject to the law, and Department of State’s Bureau of Elections concurs.

Recommendation IC-11	PSERS Response
<p><i>The Board should strengthen its “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></p>	<p>The Board will consider this recommendation. As noted before, the Board and its members are well aware of their need to maintain the highest ethical and fiduciary standards as they serve the members of the System. This includes not only avoidance of actual impropriety, but also the perception of impropriety. The Board is also pleased to note that IFS concluded that PSERS’ existing provisions governing this area are “a good start at addressing” this national issue.</p>

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 PSERS 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.

Recommendation IC-12	PSERS Response
<p><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></p>	<p>The Board will consider this recommendation. Again, the Board is well aware of its need to maintain the highest ethical and fiduciary standards as it serves the members of the System. This includes not only avoidance of actual impropriety, but also the perception of impropriety. In fact, Article V, Section 5.11 of the Board’s Statement of Organization, Bylaws, and Other Procedures (which sets forth the Board’s current recusal policy for conflicts</p>

	of interest) specifically notes that in addition to the State Ethics Laws requirements governing recusals, Board members also are governed by their higher fiduciary duties/standards.
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*Please see DAG's response at Exhibit F 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 PSERS General Consultant**

**a. Summary of the Services Provided by the Investment Consultant**

PSERS employs a nationally recognized investment consulting firm, Wilshire Associates, 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 PSERS. The following table lists the services required in the 2003 contract between PSERS and its general investment consultant, Wilshire Associates and compares those required services with the services actually provided in practice to PSERS by Wilshire.<sup>122</sup>

<b>Table I-D-1- Comparison of Consulting Services</b>		
<b>Typical General Consulting Services</b>	<b>Service Required by the contract with PSERS</b>	<b>Service Provided in practice by consultant</b>
<b>FIDUCIARY STATUS</b>		
• Consultant acknowledges fiduciary status	✓	✓
• Consultant is a registered investment advisor	✓	✓
<b>ESSENTIAL SERVICES</b>		
<i>Asset Allocation and Asset/Liability Studies</i>		
• Produce capital markets assumptions		✓
• Produce asset allocation study and recommendations	✓	✓
• Produce asset/liability report		✓

<sup>122</sup> Wilshire began its work for PSERS in 1997. Its contract with PSERS was renewed in 2003 for an additional term of five years.

<b>Table I-D-1- Comparison of Consulting Services</b>		
<b>Typical General Consulting Services</b>	<b>Service Required by the contract with PSERS</b>	<b>Service Provided in practice by consultant</b>
<b><i>Investment Policy and Structure</i></b>		
• Prepare or review fund's Investment Policy Statement	✓	✓
• Review and recommend fund's investment structure	✓	✓
• Recommend performance benchmarks for asset classes and investment managers	✓	✓
<b><i>Periodic investment performance reports</i></b>		
• 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		✓
• Monitor personnel, process and business issues at external managers	✓	✓
<b><i>Selection of external investment managers</i></b>		
• Recommend external investment managers	✓	✓
• Prepare profiles or analysis of recommended external managers	✓	✓
• Prepare guidelines for managers hired by Fund		
<b><i>Review of internal investment staff</i></b>		
• Review capabilities and structure of internal investment staff	✓	IFS did not see documentation of this activity
• Track performance of internal investment staff		✓
<b><i>Board Meetings, Education and Research</i></b>		
• Attend Board Meetings	✓	✓
• Advise on other investment subjects	✓	✓

<b>Table I-D-1- Comparison of Consulting Services</b>		
<b>Typical General Consulting Services</b>	<b>Service Required by the contract with PSERS</b>	<b>Service Provided in practice by consultant</b>
<ul style="list-style-type: none"> <li>Conduct educational programs for Board and staff</li> </ul>		✓
<ul style="list-style-type: none"> <li>Provide research papers on investment topics</li> </ul>		✓
<b>COLLATERAL SERVICES (to be provided if requested by Fund)</b>		
<i>Real estate analysis or manager selection</i>	N.A. Fund uses specialty consultant	N.A.
<i>Hedge fund analysis or selection</i>	✓	✓
<i>Private equity analysis or selection</i>	N.A. Fund uses specialty consultant	N.A.
<i>Check compliance of external managers with Fund guidelines</i>		
<b>SECONDARY SERVICES</b>		
Custodial evaluation or monitoring		
Securities lending analysis		
Brokerage analysis		
Commission recapture or brokerage discount analysis		
Advice on transition management services		
Proxy voting or analysis of other party's voting record		

As part of its agreement to provide consulting services, Wilshire makes available its Compass database of investment manager performance. This database is thorough and comprehensive and it offers the Fund's staff the ability to undertake research on thousands of investment managers and to evaluate independently managers recommended by Wilshire as well as to evaluate its own portfolios through an automatic download feature.



**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 documentation and recommendations, the investment policy statement and structure analysis, regular quarterly investment performance reports, and investment manager oversight documentation. 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 PSERS 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 Generally Consistent  
with the Needs of PSERS***

Wilshire Associates has provided investment consulting services to PSERS since 1997 and their agreement was renewed in 2003. As noted above, the investment consultant advises PSERS on asset allocation, investment policy, selection of external investment managers, and investment performance.

Based on IFS' experience, Wilshire's consulting services are of appropriate quality to meet the needs of PSERS and are consistent with industry practices. The consultant's work that

we reviewed is of high quality and the reports prepared by the consultant are comprehensive and clear. The consultant is highly regarded by the Board and staff.

The Fund, however, could benefit from having Wilshire provide advice and perspective on several collateral issues related to compliance monitoring, custodial operations, brokerage, transition management and proxy operations. These issues are not central to the structure of the Fund's investment program (e.g., asset allocation, investment structure, manager selection, etc.), but Wilshire should have substantial experience with the ways in which its other pension fund clients organize their compliance, custodial, brokerage and proxy services. Wilshire may be able to help the Fund manage risks (compliance), achieve greater efficiencies in investment operations (custody services), generate additional revenue (securities lending), reduce costs (brokerage and transition management) and strengthen performance of fiduciary duties (proxy voting). All of these subjects are discussed elsewhere in our report in more detail.

Recommendations ID-1, ID-2 and ID-3	PSERS Response
<p><i>Consider expanding Wilshire's contractual scope of services to include advice on the quality and effectiveness of, and if appropriate, selection of:</i></p> <ul style="list-style-type: none"> <li>• <i>Custodial operations and services</i></li> <li>• <i>Securities lending services</i></li> <li>• <i>Brokerage services</i></li> <li>• <i>Transition management services</i></li> <li>• <i>Proxy voting services</i></li> </ul> <p><i>Should the Fund elect to retain third party vendors to provide these services, Wilshire should provide the Fund with periodic review of the work of these vendors.</i></p>	<p>PSERS agrees that, <u>if needed</u>, it should contract with a third party, possibly the general investment consultant, for assistance on these issues. PSERS believes, however, that for most general issues the staff has the requisite expertise to review the work of these third party vendors. Therefore, PSERS cannot justify the additional cost of engaging a third party vendor until one is actually needed.</p>
<p><i>Consider expanding Wilshire's contractual scope of services to include advice on procedures to monitor the extent to which the Fund's external investment managers comply with the guidelines established by the Fund for each manager.</i></p>	<p>PSERS will consider this recommendation; however, PSERS believes that the staff already performs these functions and does not believe that incurring additional costs for a third party review would add any significant value.</p>

Recommendations ID-1, ID-2 and ID-3	PSERS Response
<p><i>In particular, Wilshire should provide advice to the Fund about how best to enhance the Fund's existing program to monitor compliance, combining both internal resources and external services (where appropriate).</i></p>	<p>PSERS will consider this recommendation; however, PSERS believes that the staff already performs these functions and does not believe that incurring additional costs for a third party review would add any significant value.</p>

***The Contract with Wilshire Does Not Identify the Fiduciary Standard of Care Binding on Wilshire***

Investment consultants give strategic advice to fund trustees and staff. If the consultant has earned the trust of the client, the client will use that advice to make some of the most important decisions affecting the financial success of the fund. Consultants should be willing to back that advice with the full strength of their experience and conviction. They can do so by agreeing to serve the fund in a fiduciary capacity, a step that represents best practice in the consulting industry. In the absence of this commitment, a fund risks that the quality of advice it receives from its consultant may not be the highest.

Wilshire's contract with PSERS includes a "Whereas" clause in which Wilshire represents that it will act in a "fiduciary capacity" but the body of the contract does not identify a particular fiduciary standard of care or, more particularly, reference Pennsylvania law's fiduciary standard applicable to PSERS.

Recommendation ID-4	PSERS Response
<p><i>Wilshire's contractual scope of services should be amended to clarify that the standard of care under which the consultant serves the Fund as a fiduciary is the standard as defined by Pennsylvania state law.</i></p>	<p>PSERS agrees and will endeavor to amend the contract.</p>

### **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.<sup>123</sup> 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 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.<sup>124</sup>*

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.

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<sup>123</sup> A copy of the May 2005 SEC report on investment consultants can be found at [www.sec.gov/news/studies/pensionexamstudy.pdf](http://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](http://www.sec.gov/investor/pubs/sponsortips.htm).

<sup>124</sup> "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](http://www.sec.gov/investor/pubs/sponsortips.htm).

- 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.
- 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.

Wilshire Associates provides services, software and analysis to numerous investment management and financial services organizations. These business affiliations create the potential for a conflict of interest. However, the Fund has already taken steps to manage this potential conflict by requiring both Wilshire and the Fund's investment managers to disclose any business relationships between the consultant and managers. Fund staff reviews these reports and

reconciles any discrepancies between the managers and Wilshire. This effort to obtain disclosure and to review reports from all involved constitutes a best practice on the part of the Fund.

In May 2005, staff presented the Board with a summary of the issues raised in the SEC report and an analysis of the extent to which the practices of Wilshire Associates created conflicts for the Fund. In particular, staff noted that Wilshire sells software and analytical programs to investment managers and that the consultant maintained a broker-dealer business until 2004. Staff concluded that it “does not feel that any of these issues are material issues in our relationship with Wilshire.”<sup>125</sup> Staff described the “fiduciary comment in the [SEC] findings” as troubling and noted the importance of an investment consultant serving in a fiduciary capacity. The Board considered staff’s report but took no action.

Recommendation ID-5	PSERS Response
<p><i>The Fund’s practice of requiring the consultant to provide annual disclosure of its business relationships with all investment managers or other providers of investment services should be maintained.</i></p>	<p>PSERS agrees. In addition, PSERS will be expanding our procedures to require the disclosure of this information to the Board for each new manager recommended by staff and all investment consultants used by PSERS.</p>

### 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.

<sup>125</sup> Memo from Alan Van Noord to the Board, “SEC Staff Report Concerning Examinations of the Select Pension Consultants,” May 20, 2005.

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 selection 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 pension funds 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 PSERS Real Estate Consultant**

PSERS replaced Russell Real Estate Advisors with Courtland Partners in 2005 after Russell withdrew from this particular line of business. At the time of our review, the Fund had not yet completed a contract with Courtland, and Courtland had yet to prepare any materials or recommendations for the Fund's use. Therefore, the extent of IFS' review is inevitably limited.

Staff reports that Courtland will be expected to perform the same services as were previously provided by Russell. In an interview, Courtland confirmed that the services it intended to provide the Fund were consistent with the services an institutional investor would require from a specialist firm. These include:

- To assist staff in policy development for the Fund;
- Review of investment strategies available in the market;
- To assist staff in the design of investment procedures and due diligence methodologies;
- Asset allocation between property types and investment strategies; and
- Searches for Real Estate Investment Trust ("REIT") and pooled fund managers.

Notably, Courtland does not expect to be responsible for calculation of investment rates of return for the Fund's real estate program. Courtland reports that this function will be provided by the Fund's private equity consultant, Portfolio Advisors.

Courtland described its due diligence procedures. This description was supplemented by samples of previous work done by the firm. Taken together, these procedures and work product

indicated that the firm has appropriate experience and knowledge to serve the Fund as a specialist consultant.

Courtland is in the beginning stages of reviewing the Fund's real estate program. Its comments on the program clearly indicated that Courtland has identified the issues of greatest importance to the management of the Fund's real estate assets.

Recommendation ID-6	PSERS Response
<i>The Board should continue to employ a real estate specialist to provide a comprehensive range of real estate advisory services.</i>	The Board agrees and will continue to retain a specialty consultant for real estate where cost effective.

## 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.

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 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.

For funds of virtually any size, 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.

## 6. Review of PSERS Private Equity Consultant

PSERS employs Portfolio Advisors as its specialist consultant regarding private equity, venture capital and private debt. Portfolio Advisors first started working for PSERS in 2002 (replacing Sovereign Financial Services). Portfolio Advisors' 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. It includes responsibility for providing educational material and presentations to the Board and with frequent communication with staff.

### ***The Private Equity Consultant Demonstrates Appropriate Knowledge and Experience***

IFS reviewed the private equity consultant's reports and recommendations, the investment policy statement and structure analysis, regularly quarterly investment performance reports, and investment manager oversight documentation. 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 PSERS staff indicate 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 PSERS***

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 portfolio of private

assets. Staff and the consultant generally reach consensus on any recommendation to be taken to the Board. In this respect, the consultant appears to serve as an extension of staff (rather than an independent source of information for the Board). Staff reports a high degree of satisfaction with the work of the consultant.

<b>Recommendation ID-7</b>	<b>PSERS Response</b>
<i>The Board should continue to employ a private equity specialist to provide a comprehensive range of alternative investments advisory services.</i>	The Board agrees and will continue to retain a specialty consultant for alternative investments, where cost effective.

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

## **I-E. Securities Class Action Litigation Activities**

### **1. Background**

Pension funds across the country are increasingly being asked to lead, or become significantly involved in, securities class 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.<sup>126</sup> A NERA<sup>127</sup> 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.<sup>128</sup>

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<sup>126</sup> “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.”

<sup>127</sup> National Economic Research Associates, Inc. is a subsidiary of Mercer Inc., a Marsh & McLennan company, an international firm of economists which provide 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.

<sup>128</sup> NERA Economic Consulting report, "Recent Trends in Shareholder Class Action Litigation: Bear Market Cases Bring Big Settlements," February, 2005.

### **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 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.<sup>129</sup> 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."<sup>130</sup> 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.

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<sup>129</sup> DOL *amicus* brief submitted in *Bragdon v. Telxon Corp.*, 98 Civ. 2876 (N.D. Ohio April 28, 1999).

<sup>130</sup> Interpretive Bulletins Relating to ERISA, 59 Fed. Reg. 38,860, 38,860-61(1994).



### ***Trustees Should Adopt a Formal Securities Litigation Policy***

To address its fiduciary responsibility, and to take reasonable steps to identify, monitor and recover securities litigation claims, boards of trustees should adopt a formal securities litigation policy. The policy should (a) acknowledge that securities litigation 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/resolved;
- Enhanced participation as a class member in class actions brought and led by others, by considering filing 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 following is a list of the components that should be found in a protocol.

- **Assignment of responsibilities** -- the roles of key parties in the execution of the policy should be defined
  - *The Board* (or a Committee of the Board established for purposes of securities class action litigation)
  - *Staff and Service Providers* (e.g., monitoring firm, legal counsel, the custody bank)
- **Case Identification** – The protocol should identify the individual(s) responsible and the method to be used for *monitoring* the pension fund's portfolio and the universe of

securities litigation cases (e.g., filings sources) in order to *identify* situations in which the pension fund may have an interest sufficient under its policy to trigger *evaluation* of the claim and possible action.

- *Responsibility:* Staff and/or outside service provider (e.g., monitoring firm or law firm) may be used to perform this task

### **Case Evaluation - Phase I**

- *Process to determine eligibility to participate in the class* - review trading activity to determine whether the pension fund purchased shares during the “class period”
- *Process to determine estimated value of potential claim* - use of a predetermined formula
- *Responsibility:* Staff or outside service provider (e.g., monitoring firm or law firm; some custody banks also have the capability to perform this function) 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 include, but are 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 fund's ability to recover (e.g., company has no insurance, is bankrupt, out of business)
- **Responsibility:** This function is typically performed by an outside law firm that is experienced in performing additional due diligence on claims (“Evaluation Counsel”)<sup>131</sup> or another external service provider, in conjunction with the fund's legal staff. 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.<sup>132</sup> This recommendation is then considered by the designated parties and a determination of whether and how to proceed is made. The

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<sup>131</sup> 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.

<sup>132</sup> 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).

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;
- 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.);
- Qualifications of other lead plaintiff candidates and their counsel, and likelihood that the pension fund would be selected as 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 or lead plaintiff status, such as discovery, staff/Board time and resources needed to monitor litigation more actively.

- **Claims Management-** 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 guidelines for the custodian regarding 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;<sup>133</sup> and (e) requires that the pension fund's custodian provide monthly reports, with an annual cumulative report, to the pension fund, for each notice of settlement received. The report should identify:

- Name of security and date notice of settlement received;
- Class period for each notice;
- Due date for claim filing;

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<sup>133</sup> The details of the securities litigation internal audit process should be set forth in a separate audit procedure.

- Date claim filed;
- Identification of accounts to which the settlement proceeds will be credited;
- Date payment received and amount of payment; and
- 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,<sup>134</sup> to work with staff in developing the specific litigation strategy and to develop a budget that is in the best interest of the class.

Some pension funds, while acknowledging that they may have a fiduciary duty to pursue legal action to recover 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 on a

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<sup>134</sup> 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 consider Evaluation Counsel as a candidate for Litigation Counsel.

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.

## **2. Review of PSERS' Current Securities Litigation Practices**

### **a. PSERS' Securities Litigation Program**

PSERS has adopted a formal, written securities litigation policy. The original policy was adopted by Board resolution in 1999. In addition to the formal policy, the PSERS securities litigation program is memorialized in three documents, each inextricably tied together and necessary to a complete understanding of PSERS' securities litigation practices:

- Resolution adopted by the Board of Trustees on September 19, 2003, and amended on September 9, 2004 and on June 3, 2005; and last reviewed by PSERS' Chief Counsel on January 3, 2006. The Securities Litigation Policy of the Commonwealth of Pennsylvania Public School Employees' Retirement Board is incorporated into the Resolution (the "Securities Litigation Policy" or the "Policy");
- Steps in Securities Litigation Process for PSERS, which contains the procedural steps incident to making a decision whether to proceed with litigation (or another course of action); and
- Class Action Settlement Procedures, which contains the procedures employed by PSERS in identifying and monitoring potential securities litigation cases.

While each of these documents covers a discrete aspect of PSERS' securities litigation program, the various documents often contain general references to procedures that are found in one of the related documents. For example, Section III.B of the Securities Litigation Policy has a general statement relating to monitoring securities litigation claims. However, unknown to the



reader, a more detailed discussion on the securities monitoring procedures is found in the document entitled “Class Action Settlement Procedures”.

Nonetheless, the new Securities Litigation Policy sets forth a more deliberative approach, expresses the intent of the PSERS Board to coordinate with SERS (when appropriate) and grants management of the Policy to the Corporate Governance Committee. The current Policy also acknowledges the fiduciary duty of the board members to take reasonable and appropriate steps to identify, monitor and recover securities litigation claims and establishes a minimum loss threshold of \$25 million. It does not, however, identify the Board’s objectives for pursuing an active role in lieu of relying on the fund’s status as a passive member of the class.

**b. PSERS’ Securities Litigation Process**

***Documentation Removes Uncertainty Regarding Who  
is Responsible for What, When, and How -  
Mitigating Both Operational and Performance Risk***

**i. Role of Custodian in the Claims Management Process**

A pension fund’s custodian is indispensable to its securities class action activities. Therefore it is essential that the custodian’s duties and responsibilities be clearly established in a written document. Such duties typically include, but are not limited to: maintenance of records, the duty to notify, the general duty to act, and the duty to submit claims. The RFP for custodial services issued by the State Treasurer requested that bidders propose their method for claims management.

We understand that the custodian bank’s (Mellon) actions and responsibilities are governed by the Master Custody Agreement. The Master Custody Agreement includes an attachment, entitled “Class Actions” (see Exhibit D to the Master Custody Agreement). This Exhibit generally obligates Mellon Bank to monitor class action information and file “viable” claims on behalf of PSERS.

The Master Custody Agreement does not contain a documented process for tracking and monitoring class action litigation, filing proofs of claim, or monitoring the receipt of class action settlement proceeds. However, PSERS has developed a rationalized process for securities litigation claims management, which is administered by PSERS' investment accounting staff and memorialized in the document entitled "Class Action Settlement Procedures." These procedures provide for greater oversight and accountability in the fund's prudent preservation of plan assets. We believe the procedures in PSERS' claims monitoring protocol cover the appropriate substantive aspects of an effective monitoring process. With respect to the custodian's responsibilities, however, we believe PSERS should request that more detail be provided in the Master Custody Agreement.

**ii. Securities Litigation: Case Identification and Monitoring Processes**

**a) Case Identification**

The PSERS board accepts the premise that class action settlement proceeds are assets of the fund. Therefore, it is imperative that the trustees insure that the fund has adequate procedures in place to identify claims, process the claims and monitor the entire claims process, including accounting for settlement proceeds received by the fund. These procedures are typically executed internally, through the investment, investment accounting or audit staffs, and are often supplemented by external service providers, such as the custodial bank and other third-party claims monitoring service providers.

The specifics of the case identification process are typically set forth in a securities litigation implementation protocol. The following is a list of functions the implementation protocol should address:

- a. How information about lawsuits filed by others, in which the pension fund may be a class member, will be gathered. This function may be performed by staff or an external monitoring firm. Methods to gather the information include:
- Staff subscribes to or follows publicly available resources (e.g., Stanford Class Action Clearinghouse, Investor Responsibility Resource Center, Investor Responsibility Support Services, Inc. (“IRSS”), law firm websites, etc.).
  - Custodian or Class Action Monitoring Firm forwards to staff all notices of pendency under the PSLRA and other notices it receives of the filing of class actions.
  - Fund contracts with custodian or other service provider to identify cases filed by others and reviews this information against the Fund’s holdings and transactions (unless Fund staff can perform the function).<sup>135</sup>
- b. How potential claims, not yet the subject of litigation, will be identified. Options include:
- Establish triggers for custodian/managers to report significant losses to staff;
  - Staff follows news developments in industry; and

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<sup>135</sup> Based discussions during the interview process and on documents we reviewed, PERS uses IRSS to identify and monitor claims. Additionally, it was brought to our attention that PSERS also uses **ISS (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 vote recommendations for more than 33,000 companies across 115 markets worldwide). **Stanford Law School Securities Class Action Clearinghouse** is an authoritative source of data and analysis regarding the financial and economic characteristics of federal securities fraud class action litigation, which can serve as an additional information source.

- Fund contracts with service provider (generally a law firm) to review portfolio for potential claims.
- c. Whether the custodian, staff or an external service provider calculates losses pertinent to claims to determine if dollar loss thresholds are met, including:
- The predetermined formula that is to be used to calculate losses<sup>136</sup> ;
  - What loss calculations should be preserved and for how long.
- d. Delineation of the contractual requirements and responsibilities of the custodian and other service providers, including:
- The specific processes and resources service providers must contractually commit to dedicate to the services;
  - The strict timeframes for delivery of data in view of the time constraints imposed by the PSLRA;
  - Continuity of services if agreement with service provider terminates (e.g., require custodian to continue to provide data/calculations after agreement terminates);
  - Requiring service providers to assume fiduciary responsibility for services it provides to the fund; and

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<sup>136</sup> Under the PSLRA, recoverable damages are calculated by comparing an investor's purchase price for a security against the average price during a period following the end of the class period, and price fluctuations unrelated to the securities law violations are factored out in a highly technical process. The resulting "damages" figure can be very different from the investor's raw loss calculated by reference only to the amount by which the value of the stock dropped during the class period.

- Requiring that conflicts of interest be avoided (e.g., a law firm that identifies and evaluate claims in a particular case may not be suitable as litigation counsel in the same case).

### **iii. PSERS' Case Identification and Monitoring Procedures**

PSERS has established a fairly elaborate and impressive process for identifying and filing potential class action claims, which includes an on-going monitoring component and pre and post-claims filing audits. These procedures are memorialized in a document entitled "Class Action Settlement Procedures."

Beginning with the notification procedures, in addition to obtaining notification of settlements from three primary sources, the custodial bank, ISS and IRSS, in some instances, PSERS obtains notification directly from the claims administrator. It appears that ISS and IRSS perform the same functions under the protocol. If that is true, we question the need to engage both ISS and IRSS in this regard, two third-party informational sources that provide the same service – for a fee.

With regard to pre-November 2, 1998 claims, PSERS sends hard-copies of transaction data prepared by FCS (and reviewed by PSERS) to Mellon for filing purposes. Since this information is provided by FCS to PSERS in electronic form, to reduce potential errors and save time, we suggest that PSERS investigate whether it is worthwhile to forward the transaction data files to Mellon in electronic form.

PSERS has also incorporated month-end reconciliation processes so that staff will know the status of all claims, including whether they are pending, under review by Mellon, or actually filed by Mellon. This is a good practice that should alert PSERS to any problems, such as failure to identify a potential claim, prior to the applicable filing deadline.

Monthly monitoring procedures undertaken by the investment accounting staff also include an audit of transaction data submitted by Mellon on each notice of claim form and a final audit of cash receipts. Both measures are highly recommended by IFS. We also note that PSERS audits settlement “pools” greater than \$75 million for completeness and accuracy. Failure on the part of the custodian bank to file and/or significant mistakes or delays by the custodian in completing the proofs of claim forms can cost a pension fund millions of dollars in lost revenues. Thus, institutionalizing periodic examinations of the custodian’s claims filing practices is appropriate and will ensure that PSERS recovers its proportionate share of all securities litigation settlements.

While the procedures in place are very good, we believe the securities litigation monitoring procedures could be enhanced through inclusion of the following provisions, as outlined above:

- Identification of specific processes and resources service providers must contractually commit to dedicate to the services;
- Inclusion of strict time frames for delivery of data in view of time constraints imposed by the PSLRA;
- A provision for continuity of services in the event an agreement with a service provider is terminated (e.g., require custodian to continue to provide data/calculations after agreement terminates);
- A requirement that service providers assume fiduciary responsibility for services it provides to the fund; and
- A requirement that service providers avoid conflicts of interest.

In addition, from an accountability standpoint, we believe the procedures would be more effective if PSERS identified who is responsible for each task, i.e., who is responsible for each step of the process. This way, the rules and lines of authority are clearly established and these responsibilities do not become secondary to other staff responsibilities. This is particularly true of the monitoring and audit procedures.

We also understand that a new master custodial agreement between the Commonwealth of Pennsylvania Treasury Department and Mellon Bank is under negotiation. Since Mellon plays such an integral role in the claims filing process, its responsibilities and the interplay between the custodian and PSERS with regard to the claims filing and monitoring processes and the expectations of both parties should be clearly articulated in the Master Custodian Agreement.

#### **a) Case Evaluation Process**

The case evaluation process is the decision-making framework used to determine whether the benefits of engaging in proactive litigation substantially outweigh the associated costs of active participation or otherwise merit additional consideration. The evaluation process should establish specific criteria and steps for deciding the nature and level of the pension fund's involvement in a case, i.e., whether or not to take an active or passive role or opt-out of the class.

The current PSERS Policy establishes a minimum threshold of \$25 million for seeking lead or co-lead plaintiff status. Some pension funds use a series of minimum thresholds in their securities litigation policies to determine the level of participation. For example, a loss of \$25 million may justify considering becoming actively involved in a case (e.g., seeking lead plaintiff or supporting or opposing another applicant for lead plaintiff); a loss of more than \$10 million but less than \$25 million may justify playing an enhanced passive role, which could include review of the terms of any settlement, including applications for legal fees, determining if the fund should file a comment or objection with respect to the settlement, or opt out of the class; and a loss of less than \$1 million may only justify passive involvement, expending the resources

necessary to insure proofs of claim will be filed on behalf of the pension fund upon settlement of relevant class actions.

The current PSERS Policy authorizes the retention of “not more than two consultants to advise PSERS on matters related to securities litigation, including assisting PSERS in analyzing its interest in both pending and potential securities litigation based upon PSERS’ holdings and exposure during the relevant periods, including identification of the specific benefit to PSERS in pursuing litigation, risk and value assessment, damage estimates, and recovery projections.” However, the Policy does not include the decision-making framework for analyzing potential cases, which is a fundamental component of the securities litigation process, nor does the Policy identify and define the specific roles of the entities in the evaluation process.

***The Absence of a Clearly Defined Process  
and the Duties of the Entity Responsible for the  
Process Subjects PSERS to Implementation Risk<sup>137</sup>***

With the exception of establishing a threshold amount, neither the current PSERS Securities Litigation Policy nor any of the related securities litigation program implementation documents establish the decision-making parameters and identify the issues or matters to be considered by the Board in evaluating potential securities litigation cases.

Pursuant to the new Policy, the Board has delegated responsibility to the Corporate Governance Committee:

- To establish and modify, as it deems desirable, general principles consistent with this Policy to consider in determining whether PSERS should participate in securities litigation and in what capacity, with a general requirement of at least a

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<sup>137</sup> “Implementation risk” is the risk that policies and procedures may not be implemented properly. Source: “Public Pension Systems – Statement of Key Risk and Common Practices to Address Those Risks” issued July 2000 by the Association of Public Pension Fund Auditors (APPFA) and endorsed by the Association of Public Pension Fund Auditors, the National Association of State Retirement Administrators and the National Council on Teacher Retirement.



\$25,000,000 loss to PSERS' retirement fund for PSERS to seek lead plaintiff or co-lead plaintiff status in a class action lawsuit;

- To recommend to the PSERB whether PSERS 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, and whether it should pursue litigation jointly with SERS;
- To identify for the PSERB the net added value to PSERS in pursuing a particular securities litigation;
- To take such further actions as the Corporate Governance Committee deems necessary or desirable to effect the desired results in the exercise of the foregoing and to comply with applicable laws and regulations.

As discussed above, these threshold determinations regarding whether to participate in litigation, when to participate and under what circumstances PSERS will participate in litigation should be consolidated into a rational, deliberative and documented process.

We also note that the criteria to be used for the selection of consultant(s) to assist PSERS in its review of potential cases,<sup>138</sup> the information the consultant(s) must provide, the timeframes for providing such information, and to whom the information must be provided are not addressed in the Policy.

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<sup>138</sup> We were informed that, during the fiduciary review period, PSERS issued an RFP for a securities litigation consultant. We were not aware of the issuance of the RFP. We were provided a copy of the RFP on February 14, 2006. We believe it is comprehensive and have no issues with it.

### 3. Comparison of PSERS' Securities Litigation Policies and Processes to Other Public Pension Funds

For purposes of comparing PSERS' 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.

<b>Table I-E-1 - Comparison of PSERS Policies and Processes to Other Pension Funds</b>						
Pension Fund	Adopted Formal Policy	Minimum Loss Threshold	Primary Responsibility for Identification, Monitoring, and First-Tier Evaluation	Primary Responsibility for 2 <sup>nd</sup> -Tier Case Evaluation	Management of Policy	Final Decision to Proceed
SERS <sup>139</sup>	X <sup>140</sup>	\$3M	IRSS	External Law Firm(s)	Securities Litigation Committee	Board and Attorney General
PSERS <sup>141</sup>	✓	\$25M <sup>142</sup>	IRSS	External Law Firm(s)	Corporate Governance Committee	Board and Attorney General
SWIB <sup>143</sup>	✓	\$25M	Staff w/ IRSS Evaluation Counsel <sup>144</sup>	External case review counsel	Legal Dept.	Board
NYC <sup>145</sup>	✓	X	IRSS	External Law Firm(s)	City Law Dept. and Comptroller	Boards
CalPERS <sup>146</sup>	✓	\$2M <sup>147</sup>	Staff w/IRSS	External Law Firm(s)	Legal Dept.	Investment Committee
CalSTRS <sup>148</sup>	✓	\$5M <sup>149</sup>	Staff	External Law Firm(s)	Legal Office and Subcommittee on Corporate Governance/Investment Committee.	Subcommittee on Corporate Governance/Investment Committee.

<sup>139</sup> Pennsylvania State Employees Retirement System

<sup>140</sup> Resolution 2003-49 established the Securities Litigation Committee and its duties and responsibilities and defines the minimum loss threshold.

<sup>141</sup> Pennsylvania Public School Employees' Retirement System

<sup>142</sup> 21 cases have exceeded PSERS' threshold since 1999.

<sup>143</sup> SWIB – State of Wisconsin Investment Board

<sup>144</sup> "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.

<sup>145</sup> Five pension fund boards, collectively the New York City Retirement Systems (Employees, Teachers, Police, Fire, and Board of Ed.).

<sup>146</sup> California Public Employees Retirement System

<sup>147</sup> CalPERS has been considering raising its minimum threshold for several years, but has not done so.

Table I-E-1 - Comparison of PSERS 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 <sup>nd</sup> -Tier Case Evaluation	Management of Policy	Final Decision to Proceed
LACERA <sup>150</sup>	✓	\$2M	IRSS	External Law Firm(s)	Legal Office	Board of Investments
OPERS <sup>151</sup>	✓	\$10M	IRSS	External Law Firm(s)	Legal and Corporate Governance	Board <sup>152</sup>

Based on a comparison of PSERS policies and processes to other pension funds, we found no significant differences.

Recommendations IE-1, IE-2, IE-3, IE-4, IE-5, IE-6, and IE-7	PSERS Response
<p><i>We recommend that PSERS cross-reference each of the documents that collectively comprise the fund's securities litigation program to facilitate a better understanding of the operational framework that PSERS has in place to manage and implement the fund's securities litigation program.</i></p>	<p>PSERS agrees and will endeavor to implement this recommendation by combining the various documents mentioned. PSERS appreciates IFS' recognition that "PSERS' new Securities Litigation Policy sets forth a more deliberative approach;" that PSERS has "established a fairly elaborate and impressive process for identifying and filing potential class action claims, which includes an on-going monitoring component and pre and post-claims filing audits;" and that PSERS' "month-end reconciliation processes" are "a good practice that should alert PSERS to any problems, such as failure to identify a potential claim, prior to the filing deadline." Considering that these various procedures have been developed at different times,</p>

<sup>148</sup> California State Teachers Retirement System

<sup>149</sup> 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.

<sup>150</sup> Los Angeles County Employees Retirement Association

<sup>151</sup> Ohio Public Employees Retirement System

<sup>152</sup> 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.

Recommendations IE-1, IE-2, IE-3, IE-4, IE-5, IE-6, and IE-7	PSERS Response
	PSERS recognizes the desirability to codify them in one document.
<i>The PSERS Securities Litigation Policy should be amended to state PSERS' objectives in pursuing active litigation.</i>	The Board will consider this recommendation.
<i>We recommend that PSERS do a cost-benefit analysis of the value-added, if any, in having two firms, ISS and IRSS, perform identical claims identification and monitoring functions.</i>	PSERS will consider this recommendation. PSERS notes that while there is some overlap in the information provided by the two firms, each also provides additional different information that is helpful to PSERS. The Office of Chief Counsel primarily uses one of the firms. It was retained specifically to calculate PSERS' losses under NAPPA-established formulas as soon as a class action securities litigation matter is initiated so that PSERS can determine whether to seek active participation in the matter. The other firm is primarily used by PSERS' Investment Accounting Division to support the Class Action Settlement Procedures to assure PSERS receives all settlement monies it is due. Any duplicate information received from both firms is used as a control check. Thus, there is a benefit to using both firms since neither firm, individually, can meet all of PSERS' class action information needs.
<i>We recommend that PSERS identify the specific resources required of its service providers, the applicable timeframes for delivery of services and/or data, and any additional requirements, such as a requirement that service providers avoid conflicts of interest, and incorporate these requirements into the claims filing protocol.</i>	PSERS will consider this recommendation.
<i>We recommend that PSERS amend the Class Action Settlement Procedures protocol to include clear lines of authority for each step of the securities litigation claims monitoring process.</i>	PSERS will consider this recommendation.

Recommendations IE-1, IE-2, IE-3, IE-4, IE-5, IE-6, and IE-7	PSERS Response
<p><i>We recommend that PSERS request the inclusion of a more detailed description of the claims monitoring process in the Master Custody Agreement, to ensure that all parties understand their respective roles in the securities litigation claims identification and monitoring process. We also recommend that the custodian be required to accept fiduciary responsibility for filing claims.</i></p>	<p>PSERS agrees to discuss this recommendation with the Treasury Department. PSERS notes, however, that the current claims monitoring process between PSERS and the custodian bank is functioning very well. Moreover, the current Master Custody Agreement already requires the custodian bank to provide all services thereunder as a fiduciary.</p>
<p><i>We recommend that PSERS adopt a case evaluation process which clearly defines the steps that must be performed in assessing the cost/benefit of PSERS' involvement in a particular case, which should include: (1) a statement of objectives in pursuing securities litigation cases; (2) the factors that will be considered – and by whom – in making the determination of whether and how to proceed in a case; and (3) identification of the parties responsible for implementation of each step of the process. The case evaluation process should be incorporated into the Securities Litigation Policy.</i></p>	<p>PSERS will consider this recommendation.</p>

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

\* \* \* \*

**PSERS CUSTOM PEER GROUP SURVEY RECIPIENTS**

**Pennsylvania State Employees Retirement System (SERS)**

**Arizona State Retirement System**

**California State Teachers Retirement System (CALSTRS)**

**Colorado PERA**

**Maryland State Retirement and Pension System**

**State of Michigan**

**New York State Teachers Retirement System**

**North Carolina Retirement System**

**Ohio Public Employees Retirement System**

**State Teachers Retirement System of Ohio**

**Oregon Public Employees**

**Virginia Retirement System**

**Washington State Investment Board (WSIB)**

**State of Wisconsin Investment Board (SWIB)**

**PSERS CUSTOM PEER GROUP SURVEY RESPONDENTS**

**Pennsylvania State Employees Retirement System (SERS)**

**Maryland State Retirement and Pension System**

**State of Michigan**

**Ohio Public Employees Retirement System**

**State Teachers Retirement System of Ohio**

**Oregon Public Employees**

**Washington State Investment Board (WSIB)**

**State of Wisconsin Investment Board (SWIB)**

**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 internal<sup>1</sup> and external<sup>2</sup> management used and the number of external managers utilized.

<sup>1</sup> 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.

<sup>2</sup> 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.





<b>Publicly Traded Assets – Asset Allocation</b>					
<b>Domestic publicly traded equities</b>	<b>Amt. (\$ Billions)</b>	<b>Percentage of Total Fund Asset Allocation</b>	<b>Percentage Managed</b>		<b>No. of External Managers</b>
			<b>Internally</b>	<b>Externally</b>	
Actively Managed					
Passively Managed					
<b>International publicly traded equities/developed markets (EAFE)</b>	<b>Amt. (\$ Billions)</b>	<b>Percentage of Total Fund Asset Allocation</b>	<b>Percentage Managed</b>	<b>Percentage Managed</b>	<b>No. of External Managers</b>
			<b>Internally</b>	<b>Externally</b>	
Actively Managed					
Passively Managed					
<b>International publicly traded equities/emerging markets</b>	<b>Amt. (\$ Billions)</b>	<b>Percentage of Total Fund Asset Allocation</b>	<b>Percentage Managed</b>	<b>Percentage Managed</b>	<b>No. of External Managers</b>
			<b>Internally</b>	<b>Externally</b>	
Actively Managed					
Passively Managed					
<b>Domestic publicly traded fixed income</b>	<b>Amt. (\$ Billions)</b>	<b>Percentage of Total Fund Asset Allocation</b>	<b>Percentage Managed</b>	<b>Percentage Managed</b>	<b>No. of External Managers</b>
			<b>Internally</b>	<b>Externally</b>	
Actively Managed					
Passively Managed					
<b>International publicly traded fixed income/developed markets</b>	<b>Amt. (\$ Billions)</b>	<b>Percentage of Total Fund Asset Allocation</b>	<b>Percentage Managed</b>	<b>Percentage Managed</b>	<b>No. of External Managers</b>
			<b>Internally</b>	<b>Externally</b>	
Actively Managed					
Passively Managed					
<b>International publicly traded fixed income/emerging markets</b>	<b>Amt. (\$ Billions)</b>	<b>Percentage of Total Fund Asset Allocation</b>	<b>Percentage Managed</b>	<b>Percentage Managed</b>	<b>No. of External Managers</b>
			<b>Internally</b>	<b>Externally</b>	
Actively Managed					
Passively Managed					
<b>Cash &amp; equivalents</b>	<b>Amt. (\$ Billions)</b>	<b>Percentage of Total Fund Asset Allocation</b>	<b>Percentage Managed</b>	<b>Percentage Managed</b>	<b>No. of External Managers</b>
			<b>Internally</b>	<b>Externally</b>	



<b>Private Assets – Asset Allocation</b>			
<b>Private equity</b> (LBOs, Venture Capital, etc.)	<b>Amt.</b> <b>(\$ Billions)</b>	<b>Percentage of Total</b> <b>Fund Asset Allocation</b>	<b>No. of External</b> <b>Managers</b>
Internally Managed			
Externally Managed			
<b>Real estate</b>	<b>Amt.</b> <b>(\$ Billions)</b>	<b>Percentage of Total</b> <b>Fund Asset Allocation</b>	<b>No. of External</b> <b>Managers</b>
<b>REITs</b>			
<b>Real estate equity</b> (all types, including developmental, fully leased, and agricultural)			
• Internally Managed			
• Externally Managed			
<b>Real estate loans</b>	<b>Amt.</b> <b>(\$ Billions)</b>	<b>Percentage of Total</b> <b>Fund Asset Allocation</b>	<b>No. of External</b> <b>Managers</b>
<b>Loans secured by real estate</b>			
• Internally Managed			
• Externally Managed			
<b>Hedge Funds</b> (Market neutral, long-short, convertible arbitrage, managed futures, global macro, etc.)	<b>Amt.</b> <b>(\$ Billions)</b>	<b>Percentage of Total</b> <b>Fund Asset Allocation</b>	<b>No. of External</b> <b>Managers</b>
Internally Managed			
Externally Managed			
<b>Other “alternative” assets</b> (including timber, oil and gas, etc.) <i>Please specify type of asset</i>	<b>Amt.</b> <b>(\$ Billions)</b>	<b>Percentage of Total</b> <b>Fund Asset Allocation</b>	<b>No. of External</b> <b>Managers</b>
Internally Managed			
Externally Managed			
<b>Commodities/Inflation Protection</b> <i>Please specify type of asset</i>	<b>Amt.</b> <b>(\$ Billions)</b>	<b>Percentage of Total</b> <b>Fund Asset Allocation</b>	<b>No. of External</b> <b>Managers</b>
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 index<sup>3</sup> 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)					

<sup>3</sup> 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   
 Brokerage Referral Arrangements   
 Soft Dollar Compensation from Brokers   
 Payments from Investment Managers for Products/Services   
 Other (Please Describe) \_\_\_\_\_

4. Please check functions performed by consultant:

- Asset Allocation Analysis   
 Manager Search   
 Drafting Manager Guidelines   
 Drafting Investment Policy Statement   
 Monitoring Manager Compliance   
 Negotiating Manager Fees   
 Preparing Quarterly Performance Reports   
 Rebalancing   
 Monitoring Custody   
 Monitoring Securities Lending   
 Transaction Cost Analysis   
 Proxy Voting Services   
 Developing Private Equity Strategy   
 Selection of Private Equity Partnerships   
 Participation on Advisory Boards   
 Developing Real Estate Strategy   
 Selection of Real Estate Partnerships   
 Other



**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 Cost<sup>4</sup>

	In Dollars	In Basis Points (relative to year-end value of the assets)	Internally Managed Costs <sup>5</sup>	Externally Managed Costs <sup>6</sup>
<b>Total investment cost for the most recently completed fiscal year</b>				
<ul style="list-style-type: none"> <li>• <b>Custodial Fees</b> <ul style="list-style-type: none"> <li>○ <b>Base Fee</b></li> <li>○ <b>Transaction Fees</b></li> <li>○ <b>STIF Fee</b></li> </ul> </li> </ul>				
<ul style="list-style-type: none"> <li>• <b>Investment Consultant Fees</b></li> </ul>				
<ul style="list-style-type: none"> <li>• <b>Investment Related Administrative Costs</b> <ul style="list-style-type: none"> <li>○ <b>Investment Compensation</b></li> </ul> </li> </ul>				
<ul style="list-style-type: none"> <li>• <b>Investment Mgmt Fees</b></li> </ul>				
<b>Please break out average Manager Fee by Category:</b>				
<ul style="list-style-type: none"> <li>• <b>Active Large Cap US Equity</b></li> </ul>				
<ul style="list-style-type: none"> <li>• <b>Active Small Cap US Equity</b></li> </ul>				
<ul style="list-style-type: none"> <li>• <b>Passive US Equity</b></li> </ul>				
<ul style="list-style-type: none"> <li>• <b>Active Non-US Developed Equity</b></li> </ul>				
<ul style="list-style-type: none"> <li>• <b>Active Emerging Markets Equity</b></li> </ul>				
<ul style="list-style-type: none"> <li>• <b>Passive Intl Equity</b></li> </ul>				

<sup>4</sup> 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.

<sup>5</sup> 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.

<sup>6</sup> 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)
<b>Total Administrative Expenses (net of Investment Related Administrative Expenses shown above)<sup>7</sup></b>		
• Non-Investment Compensation		
• Other Administrative Expenses		
<b>General Overhead and Maintenance (subset of above)</b>		
• 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? \_\_\_\_\_

<sup>7</sup> 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.

	<b>Total FTEs</b>	<b>Professional FTEs</b>	<b>Support FTEs</b>
<b>Total FTEs</b>			
<b>Office of the Executive<sup>8</sup></b>			
<b>Total Investment Staff</b>			
• <b>Public Equity Investment Function</b>			
• <b>International Equity Investment Function</b>			
• <b>Private Equity Investment Function</b>			
• <b>Real Estate Investment Function</b>			
• <b>Fixed Income Investment Function</b>			
• <b>Cash and Equivalents Function</b>			
• <b>Other (Please specify below)</b>			
<b>Total Non-Investment Staff</b>			
• <b>Investment Transactions<sup>9</sup></b>			
• <b>Investment Accounting</b>			
• <b>Systems and Office Services (IT)<sup>10</sup></b>			

<sup>8</sup> 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.

<sup>9</sup> Functions in the investment transactions area generally include: defined contribution transactions, daily valued funds, trade execution/settlement, and stock distributions.

<sup>10</sup> 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 <sup>11</sup>			
• 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
<b><u>Executive Director</u></b>					
CHIEF OPERATING OFFICER					
CHIEF INVESTMENT OFFICER					
CHIEF FINANCIAL OFFICER					
<b><u>Senior Investment Officers/ Directors</u></b>					
• Public Equity					
• Private Equity					
• Fixed Income					
• Real Estate					
• Cash and equivalents					
• Other _____					
• Other _____					

<sup>11</sup> 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
<b>IO/PORTFOLIO MANAGERS</b>											
Public Equity											
Private Equity											
Fixed Income											
Real Estate											
Cash and equivalents											
External Manager Oversight											
Other _____											
<b>Portfolio Analysts</b>											
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**

<b>Benefit</b>	<b>Offered</b>	<b>Who is Eligible?</b>
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				
<b>SENIOR INVESTMENT OFFICERS/ DIRECTORS</b>				
• Public Equity				
• Private Equity				
• Fixed Income				
• Real Estate				
• Cash & Equivalents				
• Other _____				
<b>INVESTMENT OFFICERS/ PORTFOLIO MANAGERS</b>				
• Public Equity				
• Private Equity				
• Fixed Income				
• Real Estate				
• Cash and equivalents				
• External Mgr Oversight				
• Other _____				
<b>PORTFOLIO ANALYSTS</b>				
• 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
- Performance attribution
- Guideline compliance monitoring
- Collection of withheld foreign dividends
- Risk analytics
- Portfolio transition services
- Securities lending

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
- Newsletter
- Summary Plan Description
- Telephone Hotline
- Annual Report
- Annual Benefits Summary
- 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.

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**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 - PSERS Peer Group – Board Composition

System	Number of Board Members	Elected by System Members	Ex-Officio Members	Legislature's Appointees	Other
Arizona STRS	9	0	0	0	-
Colorado PERA	16	14	2	0	-
Md. State Retirement and Pension System	13	5	3	0	-
New York State Teachers	10	4	1	0	
North Carolina Retirement System	14	0	2	2	-
Ohio PERS	11	6	1	0	-
Ohio STRS	11	7	1	1 <sup>1</sup>	1 Investment expert designated by State Treasurer
Oregon PERS	5	0	2	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

<sup>1</sup> Must be investment expert.



## Exhibit E

### Summary of Recommendations

Set forth below are summaries of all recommendations from the preceding report and PSERS' responses. They are listed in the order they appear in the report with by task area for ease of reference.

Number	Recommendation(s)	PSERS Response
A-1	<i>The Board should support legislation requiring that at least one of the Governor's appointees to the Board have investment expertise.</i>	The Board believes this is a matter for the General Assembly since it requires legislative action. The Board notes, however, that it has been the long standing practice of the Commonwealth's Governors to appoint Board members with investment experience, as evidenced by the current gubernatorial appointees to the Board.
A-2	<i>The Board should develop and adopt a formal Statement of Governance Principles.</i>	The Board agrees and will endeavor to institute this recommendation.
A-3	<i>The Board should consider delegating to staff authority to make certain investment decisions related to private equity, real estate and alternative investments, subject to appropriate reporting requirements to the full Board or an appropriate Committee, as well as certain administrative decisions on personnel and other matters, subject to oversight by the Board or an appropriate committee.</i>	The Board will consider this recommendation. It should be noted, however, that the Board has already taken steps in this direction in that the Board does not require formal presentations on new investments by existing real estate, private equity and alternative investments partnerships. In addition, one goal of the planned Request for Proposal for an investment personnel consultant is to develop policies and procedures to enable delegation of certain investment personnel actions to the Staff. It is also anticipated that the suggested Statement of

Number	Recommendation(s)	PSERS Response
		<p>Governance Principles recommended above, will document and incorporate new and existing delegations of authority on a wide spectrum of administrative matters, including benefits, budgetary, procurement and operational matters.</p>
A-4	<p><i>The Board should consider restructuring its meeting format so as to allow the Committees to work as small groups to develop analysis and recommendations for the full Board.</i></p>	<p>The Board will consider this recommendation. On critical issues or long term projects, the Board has already moved in this direction having utilized agency committees (comprised of Board members and PSERS' staff), which are recognized in the Board's Bylaws, (see Article IV, Section 4.5), to develop proposals for the Board's consideration, through its existing committee structure. A current example is the PSERS Policy Review Agency Committee that is reviewing and revising, when necessary, all of PSERS existing policies. Two notable past examples are the separate agency committees that developed the new plan design for PSERS Health Options Program (HOP) and participated in incorporating Medicare Part D into the HOP plan design.</p>
A-5	<p><i>The Board should develop an Audit Committee separate from the Budget Committee.</i></p>	<p>The Board will consider this recommendation.</p>
A-6	<p><i>PSERS should complete development of an in-house accounting system to capture private investment activity so that all of PSERS investment activity is captured on the in-house system</i></p>	<p>PSERS agrees. In fact, the project to create an independent book of record for all assets of the System is a priority and is well on its way to completion.</p>

Number	Recommendation(s)	PSERS Response
A-7	<p><i>Staff should be required to acknowledge by signature the receipt of, and agreement to, all IT policies and procedures.</i></p>	<p>PSERS agrees. In fact, this is already being done through PSERS' new employee orientation program and PSERS' on-line policy for distribution system known as VPC (Vigilant Policy Center) for existing employees.</p>
A-8	<p><i>The Board should take steps to establish an internal audit function that is more in-line with mainstream or traditional internal auditing. In that regard the Board should:</i></p> <ul style="list-style-type: none"> <li>○ <i>Establish a distinct Audit Committee of the Board</i></li> <li>○ <i>Develop an Audit Committee charter</i></li> <li>○ <i>Clarify the role of IA through written communication to all staff</i></li> <li>○ <i>Issue a formal Internal Audit Charter<sup>1</sup></i></li> <li>○ <i>Increase audit staff to an appropriate level commensurate with the size and risk of the organization</i></li> <li>○ <i>Increase technology and other resources available to the Internal Audit function</i></li> <li>○ <i>Require Internal Audit to</i> <ul style="list-style-type: none"> <li>○ <i>Prepare a periodic audit risk assessment</i></li> <li>○ <i>Develop a procedure manual</i></li> <li>○ <i>Develop position descriptions</i></li> <li>○ <i>Ensure that the IT risk assessment includes information technology areas such as:</i></li> </ul> </li> </ul>	<p>The Board will consider these recommendations. Some of these recommendations, however, would be more meaningful if IFS had detailed the following:</p> <ul style="list-style-type: none"> <li>● The deficiencies in the current position description</li> <li>● The technology and other resources that IFS believes is not already available to the Internal Auditor</li> <li>● The need to re-clarify the role of Internal Auditor in a written communication to all staff</li> <li>● The deficiencies in the current procedures manual</li> </ul>

<sup>1</sup> The purpose, authority, and responsibility of the internal audit activity should be formally defined in a charter, consistent with the *Standards*, and approved by the Board. (Standards for the Professional Practice of Internal Auditing, Attribute Standard 1000. The Institute of Internal Auditors.)

Number	Recommendation(s)	PSERS Response
	<ul style="list-style-type: none"> <li>▪ data centers,</li> <li>▪ systems software,</li> <li>▪ application systems,</li> <li>▪ systems development,</li> <li>▪ end-user computing,</li> <li>▪ telecommunications, and</li> <li>▪ networks.</li> </ul>	
B-1	<p><i>The Board should work with staff and the general consultant to enhance the information the Board receives regarding the risks incurred by external investment managers.</i></p>	<p>The Board agrees and will endeavor to institute this recommendation.</p>
B-2	<p><i>PSERS should add staff to the process of conducting compliance checks of external equity and fixed income managers in order to increase the frequency of these checks.</i></p>	<p>PSERS agrees. PSERS' Investment Compliance Division has hired one additional staff member, effective July 2006, to conduct compliance reviews of external and internal public market investment managers. This personnel action should allow PSERS to meet its goals for compliance reviews.</p>
B-3	<p><i>The Board should dedicate more staff and resources to allow for more regular in-depth qualitative review of the Fund's managers.</i></p>	<p>PSERS agrees. PSERS' Investment Compliance Division has hired one additional staff member, effective July 2006, to conduct compliance reviews of external and internal public market investment managers. This personnel action will allow PSERS to dedicate more time to more regular qualitative reviews.</p>
B-4	<p><i>The Fund should enhance its monitoring procedures to meet the specific challenges created by use of new global macro 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></p>	<p>The Board agrees and will endeavor to institute this recommendation.</p>
B-5	<p><i>With respect to its internal investment managers, the Fund should enhance its monitoring procedures in the same was as</i></p>	<p>PSERS agrees. As noted in the report, however, PSERS has already instituted similar monitoring</p>

Number	Recommendation(s)	PSERS Response
	<i>for external investment managers.</i>	procedures for the internal public market investment managers as it has for the external public market investment managers.
B-6	<i>The Fund should enhance its trading systems to include automated pre-trade compliance checks of any securities purchased.</i>	PSERS agrees and will endeavor to institute this recommendation.
B-7	<i>As the Fund increases its direct purchase of futures, options, swap contracts, or other derivative securities, it must develop stronger internal controls to minimize the potential for operational errors, unauthorized transactions, or misspecified hedges that have harmed other institutional investors in currency and derivative markets.</i>	PSERS agrees and will endeavor to institute this recommendation.
B-8	<i>PSERS investment staff should consider creating one custom investment guideline document for every investment manager, rather than using the standard more general Addendums and customized amendments.</i>	PSERS will consider this recommendation. As noted, however, PSERS has standard investment guidelines that are customized, through amendments, to meet each manager's investment process. This allows PSERS to maintain a standard policy statement that lays the foundation for each mandate that can then be tailored for each manager's specific mandate.
B-9	<i>The Board should reconsider its requirements for guideline monitoring and work with staff to come up with a reasonable solution.</i>	The Board agrees. PSERS' Investment Compliance Division has hired one additional staff member, effective July 2006, to conduct compliance reviews of external and internal public market investment managers. This personnel action should allow PSERS to meet its goals for compliance reviews.
B-10	<i>With respect to private equity and real</i>	The Board and PSERS agree and

Number	Recommendation(s)	PSERS Response
	<i>estate, the Fund's methods for monitoring managers and investments are sound and should be maintained.</i>	are pleased that IFS has determined that PSERS is complying with best practices in this area.
B-11	<i>The Board and staff should consider whether it should be the Fund's practice to participate on as many advisory boards as possible, or whether staff should prioritize the time it invests in advisory board work.</i>	The Board will consider this recommendation. PSERS understands the point that IFS is making; however, staff uses the time on advisory boards for two important purposes. First, oversight of existing investments and second, as due diligence on the general partnerships which is then used to assist in future decisions on investment in the general partner's next fund. In short, at this time PSERS finds the opportunity costs higher by not participating on the advisory boards. Notwithstanding, PSERS is in the process of hiring one additional staff member in the Alternative Investment area that will help with the Advisory Board workload.
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 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 PSERS attorney's authority, as well as the relationship between the PSERS attorney and the Commonwealth</i>	The Board believes this is a matter for the General Assembly since it requires legislative action. It should be noted, however, that over the years the issue of independent counsel for PSERS and SERS has been raised at various times by legislative members of both parties. Notwithstanding, the General Assembly has not taken any action to change the legal representation of either PSERS or SERS. Regardless of any legislative action that may or may not be taken, the Board believes that the legal services rendered to the System and the Board should be rendered

Number	Recommendation(s)	PSERS Response
	<i>General Counsel.</i>	by a unified legal office, whether the General Assembly determines to create an independent legal office, or, as it currently stands, is appointed by the Office of General Counsel. To do otherwise would lead to duplication of services, additional costs and/or unnecessary conflicts in advice and opinions. Finally the Board is unaware of any mechanism or process to ensure or obtain “a binding, permanent directive from the General Counsel” on this or any other administrative matter.
C-2	<i>So long as a Chief Counsel appointed by and serving at the pleasure of the Commonwealth’s General Counsel remains the PSERS attorney of record, the Board and the General Counsel should negotiate with the General Counsel 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, PSERS and/or its Board may engage its own legal counsel, and (ii) to select and compensate such separate counsel.</i>	The Board will consider this recommendation. In doing so, however, the Board notes that PSERS has had no difficulty obtaining, through the Office of General Counsel (OGC), qualified outside counsel, either in Pennsylvania or elsewhere, to handle PSERS specialized legal affairs. Similarly, there has been no recent history (fifteen plus years) in which counsel may have been needed because of a potential conflict of interest between PSERS and the Governor’s Office. Therefore the Board questions whether a Memorandum of Understanding (MOU), is necessary on that issue, especially since to negotiate such a memorandum may abrade the current good relationships between PSERS and OGC, for no reason. Finally, as noted above, such a MOU would not be permanent and

Number	Recommendation(s)	PSERS Response
		binding upon the OGC and more than likely it will not cover the one sensitive issue that may give rise to a conflict of interest in the future.
C-3	<i>The Board should support the adoption of legislation amending the Commonwealth Attorneys Act to exempt PSERS 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 PSERS Chief Counsel should continue and expand, if possible, its practice of developing 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.</i>	The Board believes this is a matter for the General Assembly since it requires legislative action. With respect to the practice of developing form contracts pre-approved by the General Counsel and the Attorney General, PSERS Office of Chief Counsel has, in fact, developed form contracts for all contracts that are possible to be pre-approved. The principal agreements still requiring formal approval are the various documents ancillary to PSERS investments in limited partnerships. Since these documents are prepared by the general partners and are negotiated individually, they do not lend themselves to pre-approval.
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>	The Board agrees and will endeavor to institute the recommendation. In doing so, the Board notes that all Board member designees are well aware that they are subject to the same fiduciary standards as the Board members they represent.
C-5	<i>The Board should amend the Bylaws to require designees to take the same oath as Board members.</i>	Although not legally required, the Board will consider this recommendation.
C-6	<i>The Board should support legislation to grant the Board autonomy in establishing its administrative budget to be paid from PSERS assets, provided that such legislation makes it clear that the Board's decisions regarding expenses to be paid</i>	The Board believes this is a matter for the General Assembly since it requires legislative action. As with the other "independence recommendations" the Board is well aware of the pros and cons of



Number	Recommendation(s)	PSERS Response
	<p><i>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 PSERS' members.</i></p>	<p>this issue. Generally speaking, however, over the years the Board has had adequate financial resources to fulfill its mission, particularly with respect to its investment functions. In fact, the Board is particularly pleased with the current Governor's Office of the Budget support for PSERS' annual administrative budget requests.</p>
C-7	<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 PSERS. 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, the Board and the State Treasurer should collaborate in establishing a mechanism whereby the PSERS 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"> <li><i>• the review of the performance of the custodian,</i></li> <li><i>• possible enhancements to the services provided by the custodian,</i></li> <li><i>• any decision to replace the custodian,</i></li> <li><i>• development of the scope of services to be provided by any new custodian and</i></li> <li><i>• the selection of a new custodian</i></li> </ul>	<p>The Board believes this is a matter for the General Assembly since it requires legislative action. Notwithstanding, over the years there has been steady progress in enhancing PSERS input to the State Treasurer's selection process for the custodian bank, including the opportunity for PSERS to request and receive, as part of the contract process, PSERS specific requirements from the custodian bank, e.g., specialized reports. Indeed, PSERS' relationship with the current State Treasurer has been excellent.</p>
C-8	<p><i>The Board should support legislation to grant the Board autonomy in procurement and personnel policies,</i></p>	<p>The Board believes this is a matter for the General Assembly since it requires legislative action. As with</p>

Number	Recommendation(s)	PSERS Response
	<p><i>provided that such legislation (i) 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 PSERS members, and (ii) that the resources of the Office of Administration remain available to PSERS on request.</i></p>	<p>the other "independence recommendations" the Board is well aware of the pros and cons of this issue. In this case, however, the Board already has independent compensation and classification authority for its investment professionals. Further, PSERS investment contracts are outside the scope of the Commonwealth's procurement law. While PSERS investment consulting contracts are subject to the Commonwealth's procurement rules, PSERS has not experienced any difficulties in complying with those rules.</p>
C-9	<p><i>The Board should review on a comparative basis the Governor's Code of Conduct, the Legislative Code 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>The Board will consider this recommendation. In doing so, the Board and its members are well aware of their need to maintain the highest ethical and fiduciary standards as they serve the members of the System. This includes not only avoidance of actual impropriety, but also the perception of impropriety. It also includes strict adherence to the existing statutory and/or regulatory requirements applicable to the Board in this area.</p>
C-10	<p><i>The Board should review the Travel Policy and consider modifying it as follows:</i></p> <ul style="list-style-type: none"> <li>• <i>Require pre-approval by the Board or the Board Chair for reimbursement for attendance at any educational program.</i></li> <li>• <i>Require approval by the Board for reimbursement for attendance at more than two educational</i></li> </ul>	<p>The Board will consider this recommendation. Indeed, the Board has already begun addressing this issue. PSERS' Policy Review Agency Committee, which consists of staff and a number of Board members, is in the process of reviewing and, when appropriate, revising all of PSERS policies, including the Board's</p>

Number	Recommendation(s)	PSERS Response
	<p><i>conferences outside the Commonwealth in a year by any one Board member.</i></p> <ul style="list-style-type: none"> <li>• <i>Review the lists of pre-approved events to assure they do not include events which present an appearance of inappropriate marketing of financial services, as opposed to purely educational functions.</i></li> <li>• <i>Supplement the Management Directive by enumerating categories of expenses for which reimbursement is not available.</i></li> </ul>	<p>current Travel and Education Policy. At present, it is anticipated that the Board will consider a revised Board Education Policy before the end of this year.</p>
C-11	<p><i>The Board should strengthen its “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></p>	<p>The Board will consider this recommendation. As noted before, the Board and its members are well aware of their need to maintain the highest ethical and fiduciary standards as they serve the members of the System. This includes not only avoidance of actual impropriety, but also the perception of impropriety. The Board is also pleased to note that IFS concluded that PSERS’ existing provisions governing this area are “a good start at addressing” this national issue.</p>
C-12	<p><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></p>	<p>The Board will consider this recommendation. Again, the Board is well aware of its need to maintain the highest ethical and fiduciary standards as it serves the members of the System. This includes not only avoidance of actual impropriety, but also the perception of impropriety. In fact, Article V, Section 5.11 of the Board’s Statement of Organization,</p>

Number	Recommendation(s)	PSERS Response
		Bylaws, and Other Procedures (which sets forth the Board's current recusal policy for conflicts of interest) specifically notes that in addition to the State Ethics Laws requirements governing recusals, Board members also are governed by their higher fiduciary duties/standards.
D-1	<p><i>Consider expanding Wilshire's contractual scope of services to include advice on the quality and effectiveness of, and if appropriate, selection of:</i></p> <ul style="list-style-type: none"> <li>• <i>Custodial operations and services</i></li> <li>• <i>Securities lending services</i></li> <li>• <i>Brokerage services</i></li> <li>• <i>Transition management services</i></li> <li>• <i>Proxy voting services</i></li> </ul> <p><i>Should the Fund elect to retain third party vendors to provide these services, Wilshire should provide the Fund with periodic review of the work of these vendors.</i></p>	PSERS agrees that, <u>if needed</u> , it should contract with a third party, possibly the general investment consultant, for assistance on these issues. PSERS believes, however, that for most general issues the staff has the requisite expertise to review the work of these third party vendors. Therefore, PSERS cannot justify the additional cost of engaging a third party vendor until one is actually needed.
D-2	<p><i>Consider expanding Wilshire's contractual scope of services to include advice on procedures to monitor the extent to which the Fund's external investment managers comply with the guidelines established by the Fund for each manager.</i></p>	PSERS will consider this recommendation; however, PSERS believes that the staff already performs these functions and does not believe that incurring additional costs for a third party review would add any significant value.
D-3	<p><i>Wilshire should provide advice to the Fund about how best to enhance the Fund's existing program to monitor compliance, combining both internal resources and external services (where appropriate).</i></p>	PSERS will consider this recommendation; however, PSERS believes that the staff already performs these functions and does not believe that incurring additional costs for a third party review would add any significant value.
D-4	<p><i>Wilshire's contractual scope of services should be amended to clarify that the</i></p>	PSERS agrees and will endeavor to amend the contract.

Number	Recommendation(s)	PSERS Response
	<i>standard of care under which the consultant serves the Fund as a fiduciary is the standard as defined by Pennsylvania state law.</i>	
D-5	<i>The Fund's practice of requiring the consultant to provide annual disclosure of its business relationships with all investment managers or other providers of investment services should be maintained.</i>	PSERS agrees. In addition, PSERS will be expanding our procedures to require the disclosure of this information to the Board for each new manager recommended by staff and all investment consultants used by PSERS.
D-6	<i>The Board should continue to employ a real estate specialist to provide a comprehensive range of real estate advisory services.</i>	The Board agrees and will continue to retain a specialty consultant for real estate where cost effective.
D-7	<i>The Board should continue to employ a private equity specialist to provide a comprehensive range of alternative investments advisory services.</i>	The Board agrees and will continue to retain a specialty consultant for alternative investments, where cost effective.
E-1	<i>We recommend that PSERS cross-reference each of the documents that collectively comprise the fund's securities litigation program to facilitate a better understanding of the operational framework that PSERS has in place to manage and implement the fund's securities litigation program.</i>	PSERS agrees and will endeavor to implement this recommendation by combining the various documents mentioned. PSERS appreciates IFS' recognition that "PSERS' new Securities Litigation Policy sets forth a more deliberative approach;" that PSERS has "established a fairly elaborate and impressive process for identifying and filing potential class action claims, which includes an on-going monitoring component and pre and post-claims filing audits;" and that PSERS' "month-end reconciliation processes" are "a good practice that should alert PSERS to any problems, such as failure to identify a potential claim, prior to the filing deadline." Considering that these various

Number	Recommendation(s)	PSERS Response
		procedures have been developed at different times, PSERS recognizes the desirability to codify them in one document.
E-2	<i>The PSERS Securities Litigation Policy should be amended to state PSERS' objectives in pursuing active litigation.</i>	The Board will consider this recommendation.
E-3	<i>We recommend that PSERS do a cost-benefit analysis of the value-added, if any, in having two firms perform identical claims identification and monitoring functions.</i>	PSERS will consider this recommendation. PSERS notes that while there is some overlap in the information provided by the two firms, each also provides additional different information that is helpful to PSERS. The Office of Chief Counsel primarily uses one of the firms. It was retained specifically to calculate PSERS' losses under NAPPA-established formulas as soon as a class action securities litigation matter is initiated so that PSERS can determine whether to seek active participation in the matter. The other firm is primarily used by PSERS' Investment Accounting Division to support the Class Action Settlement Procedures to assure PSERS receives all settlement monies it is due. Any duplicate information received from both firms is used as a control check. Thus, there is a benefit to using both firms since neither firm, individually, can meet all of PSERS' class action information needs.
E-4	<i>We recommend that PSERS identify the specific resources required of its service providers, the applicable timeframes for delivery of services and/or data, and any additional requirements, such as a</i>	PSERS will consider this recommendation.

Number	Recommendation(s)	PSERS Response
	<i>requirement that service providers avoid conflicts of interest, and incorporate these requirements into the claims filing protocol.</i>	
E-5	<i>We recommend that PSERS amend the Class Action Settlement Procedures protocol to include clear lines of authority for each step of the securities litigation claims monitoring process.</i>	PSERS will consider this recommendation.
E-6	<i>We recommend that PSERS request the inclusion of a more detailed description of the claims monitoring process in the Master Custody Agreement, to ensure that all parties understand their respective roles in the securities litigation claims monitoring process. The custodian should also be required to accept fiduciary responsibility for filing claims.</i>	PSERS agrees to discuss this recommendation with the Treasury Department. PSERS notes, however, that the current claims monitoring process between PSERS and the custodian bank is functioning very well. Moreover, the current Master Custody Agreement already requires the custodian bank to provide all services thereunder as a fiduciary.
E-7	<i>We recommend that PSERS adopt a case evaluation process which clearly defines the steps that must be performed in assessing the cost/benefit of PSERS' involvement in a particular case, which should include: (1) a statement of objectives in pursuing securities litigation cases; (2) the factors that will be considered – and by whom – in making the determination of whether and how to proceed in a case; and (3) identification of the parties responsible for implementation of each step of the process. The case evaluation process should be incorporated into the Securities Litigation Policy.</i>	PSERS will consider this recommendation.



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 15<sup>th</sup> Street, NW, Suite 1120  
Washington, DC 20005

Dear Mr. Halpern:

The Department of the Auditor General ("Department") has reviewed the draft of PSERS Report I, dated July 20, 2006, which provides the results of a portion of the "investment fiduciary review" of the Pennsylvania Public School Employees' Retirement System ("PSERS" 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 PSERS. Our response to PSERS Report II, which discusses objectives performed only by IFS, is provided in a separate letter.

In general, PSERS Report I appears to provide the management of PSERS with many reasonable recommendations as to how it can improve PSERS' 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.



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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 Limitation on the Report**

- On pages 11-12 of the report, IFS acknowledges its use of recognized “best practices” as baselines for evaluating PSERS’ performance. More specifically, on page 12, 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 PSERS and the Public School 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 PSERS 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 PSERS’ 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.

PSERS’ Board and the board of its counterpart, the State Employees’ Retirement System (“SERS”), 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 PSERS' 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 are 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 PSERS' assets. It further explains why the Governor's Office of General Counsel ("OGC") opposed the adoption of UMPERSA in 1997 and why only two states have enacted UMPERSA in its entirety. 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 17 – 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.

**Section III – Task I-A: Organizational and Management Structures and Resources**

The following comments by IFS lack clarity and/or enough detail to support the conclusion presented by IFS:

- Page 32 – IFS states that: 1) 7 of the Board’s 15 members are authorized to act through designees and many have named more than one designee; 2) the involvement of different designees for Board members has the potential to impair the Board’s continuity; and 3) it is not clear whether a Board member’s designee is subject to the same fiduciary standard as the Board member him/herself. Given IFS’ concerns, it is not clear why IFS makes no recommendation that Board members should select just one designee to act in their stead. Regardless, we do not share IFS’ concern that designees may not be subject to the same fiduciary standard as the member who designates them because it is apparent under the PSERS Retirement Code that a designee acquires the obligations of his/her principal by virtue of the designation.<sup>1</sup>
- Page 34 – IFS recommends that the PSERS 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 and appropriate reporting requirements to the full Board or an appropriate Committee, as well as certain administrative decisions on personnel and other matters, subject to oversight by the Board or an appropriate Committee.” Although the PSERS Retirement Code does not contain a specific prohibition on investment decision delegation to staff authority, we question whether such delegation will enable the PSERS Board members to exercise sufficient investment decision oversight, thus potentially compromising their ability to meet their fiduciary obligations.<sup>2</sup> In particular, Section 8521(e) of the

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<sup>1</sup> See 24 Pa.C.S. § 8501(a); 24 Pa.C.S. § 8521(e).

<sup>2</sup> In footnote 64 on page 34, 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 PSERS 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 PSERS Board members’ ability to properly carry out their fiduciary duties. Furthermore, the absence of an explicit prohibition in a statute, such as the PSERS 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.” Given that delegating these types of investment decisions, which IFS acknowledges in footnote 63 are the only asset classes in which the Board is directly involved in individual investment decision-making, to staff,

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PSERS Retirement Code imposes upon PSERS Board members “the obligation to invest and manage the fund for the exclusive benefit of the members of the system....”<sup>3</sup> In PSERS’ response to this IFS recommendation, it appears that PSERS may have fully embraced the concept of delegation of investment decisions to staff when it states that “[t]he Board will consider this recommendation. It should be noted, however, that the Board has already taken steps in this direction in that the Board does not require formal presentations on new investments by existing real estate, private equity and alternative investments partnerships. In addition, one goal of the planned Request for Proposal for an investment personnel consultant is to develop policies and procedures to enable delegation of certain investment personnel actions to the Staff. It is also anticipated that the suggested Statement of Governance Principles recommended above, will document and incorporate new and existing delegations of authority on a wide spectrum of administrative matters, including benefits, budgetary, procurement and operational matters.” We note that the delegation of operational, administrative, and personnel decision-making by an independent administrative board, such as PSERS, to professional staff is clearly within its sound discretion. However, given that the PSERS’ Retirement Code does not appear to authorize the delegation of investment decisions to staff, PSERS may wish to proceed with caution in any attempt to broaden its current practice of delegating such decisions to staff.

**Section III – Task Area I-B: Due Diligence Procedures**

We disagree with IFS’ conclusion on page 50, “PSERS Due Diligence Procedures are Thorough and Complete.” Our test work in this area, which is discussed in Chapter 4 of our report, revealed that PSERS does not have formal due diligence policies and procedures. We recommend that PSERS develop such policies and procedures, which at a minimum should include all requirements and steps in the due diligence process to ensure that the due diligence performed allows PSERS’ Board members to make, and support, informed decisions and fulfill their fiduciary duties. Chapter 4 of our report also addresses investment manager fees, which IFS does not cover in its report.

**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 PSERS Report I. In addition, the report fails to address the benefits that PSERS receives from Commonwealth agencies

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may undermine the Board members’ ability to ensure that all related investments are for the exclusive benefit of the PSERS plan members and, therefore, may not give proper effect to this provision of the PSERS Retirement Code.

<sup>3</sup> See 24 Pa.C.S. § 8521(e).

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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 PSERS 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 PSERS Board, with administrative reporting responsibility to the Executive Director. IFS further recommends that PSERS seek a formal, written 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 PSERS 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 the PSERS' Chief Counsel has had a conflict of interest in serving PSERS and its Board. In fact, IFS states on page 75 of this section that the PSERS' Chief Counsel “provides capable legal *support* to the investment function.” (Emphasis added.) This statement appears to undermine IFS' recommendation that the PSERS Board 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 PSERS to hire its own separate counsel on a case-by-case basis, which the System has exercised on occasion.<sup>4</sup>
- Page 77 – IFS recommends that the PSERS Board support the adoption of legislation amending the Commonwealth Attorneys Act to exempt PSERS from the requirement that PSERS and other state agencies must obtain approval of their contracts from the Office of Attorney General and OGC. This stems from IFS' conclusion that “no substantive positive contribution from the General Counsel or the Attorney General to PSERS' investment program as a result of their review of specific contracts has been identified,

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<sup>4</sup> PSERS' response to this IFS recommendation, in which it notes that the Board believes that the legal services rendered to the System and the Board should be rendered by a unified legal office,” lends support to our recommendation in Chapter 2 of our report that PSERS should seek complete independence of its current legal counsel and his staff if PSERS determines that it is problematic to have OGC provide it with legal services. Such action would eliminate the possibility of conflicts between the System's legal counsel and OGC counsel, as well as duplication of services.

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and some still see their involvement as at least potentially burdensome.” IFS provides no conclusive, substantive evidence (despite the fact that we had previously requested the inclusion of such evidence) as to why IFS reached its conclusion. In fact, on page 76, IFS indicates that both the General Counsel and the Attorney General have been responsive to the PSERS’ Chief Counsel’s request to complete their reviews within tight time frames. In addition, we question why PSERS should be exempted from a safeguard designed to ensure proper oversight of the contracting process. PSERS’ response to this recommendation makes it clear that PSERS has been successful in reducing the need for approvals, whenever feasible, by developing “form contracts for all contracts that are possible to be pre-approved.”

- Page 81 – IFS recommends that the PSERS Board amend its bylaws to add a provision clearly stating that designees of PSERS Board members are subject to the same standard of care as the Board members who designate them and to require designees to take the same oath as Board members. Although it is apparent that the PSERS Retirement Code subjects designees to the same standard as their principals (thus, making an oath requirement superfluous),<sup>5</sup> amending the bylaws to raise the awareness of all designees about their fiduciary obligations is a reasonable recommendation. In its response, PSERS notes that “all Board member designees are well aware that they are subject to the same fiduciary standards as the Board members they represent.”
- In this same section on page 78, IFS concludes that the PSERS 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 court,<sup>6</sup> and contains a positive obligation to diversify investments.<sup>7</sup> The PSERS 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.<sup>8</sup>

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<sup>5</sup> See 24 Pa.C.S. § 8501(a); 24 Pa.C.S. § 8521(e).

<sup>6</sup> See 20 Pa.C.S. § 7201 *et seq.*

<sup>7</sup> See 20 Pa.C.S. § 7204(a).

<sup>8</sup> See 20 Pa.C.S. § 7203(a). We also note that UMPERSA, which IFS relies upon heavily 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

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Chapter 2 of our report includes a thorough discussion of this issue and recommends that the PSERS Board pursue changes to the PSERS Retirement Code to ensure that the prudence standard applicable to the PSERS 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 PSERS.

- Page 86 - IFS recommends that the PSERS 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 PSERS and SERS 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. PSERS' response to this IFS recommendation lends support to our conclusion: "[O]ver the years the Board has had adequate financial resources to fulfill its mission, particularly with respect to its investment functions. In fact the Board is particularly pleased with the current Governor's Office of the Budget support for PSERS' annual administrative budget requests."
- Page 88 - IFS recommends that the PSERS Board support legislation to grant the PSERS 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 noted 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 PSERS 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 PSERS plan. PSERS' response to this recommendation underscores the fact that the time and expense of pursuing a change to state law may not yield any tangible benefits: "[O]ver the years there has been steady progress in enhancing PSERS input to the State Treasurer's selection process for the custodian bank, including the opportunity for PSERS to request and receive, as part of the contract process, PSERS' specific requirements from the custodian bank, e.g., specialized reports. Indeed, PSERS' relationship with the current State Treasurer has been excellent."

- Page 90 – IFS recommends that the PSERS Board pursue legislation granting the System 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 PSERS and SERS should be the only executive branch agencies exempted from these requirements. In its response to IFS, PSERS points out that “the Board already has independent compensation and classification authority for its investment professionals. Further, PSERS investment contracts are outside the scope of the Commonwealth’s procurement law. While PSERS investment consulting contracts are subject to the Commonwealth’s procurement rules, PSERS has not experienced any difficulties in complying with these rules.”
- Page 92 – IFS recommends that the PSERS 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 PSERS Board adopt enhanced ethics policies to ensure that the policies properly reflect the fiduciary duties of Board members of a public pension plan like PSERS.
- Page 97 – IFS also recommends that the PSERS 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 PSERS' investment consultants and reasonable recommendations for changes that could help PSERS more effectively accomplish its mission. However, IFS does not fully address the potential conflicts of interest that exist between PSERS' general consultant and



Samuel W. Halpern, President  
INDEPENDENT FIDUCIARY SERVICES, INC  
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investment managers when this consultant makes recommendations to the PSERS Board. 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 litigation process and reasonable recommendations for changes that could help PSERS 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.

The Department of the Auditor General appreciates the opportunity to submit these comments on IFS' final PSERS 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,



**JACK WAGNER**  
Auditor General

cc: Jeanna M. Cullins, Senior Vice President, IFS  
Andrew Irving, General Counsel, IFS  
Jeffrey B. Clay, Executive Director, PSERS  
Donald J. Halke, Internal Auditor, PSERS  
Gerald Gornish, Chief Counsel, PSERS

Commonwealth of Pennsylvania  
Public School Employees' Retirement  
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Commonwealth of Pennsylvania  
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