


COMMONWEALTH OF PENNSYLVANIA
PUBLIC SCHOOL EMPLOYEES' RETIREMENT SYSTEM
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DATE: January 11, 2008

SUBJECT: Auditor General Performance Audit and IFS Fiduciary Review
Follow-up

TO: Audit/Budget Committee

FROM: Jeffrey B. Clay, Executive Director 

At the Audit/Budget Committee meeting on January 24, 2008, staff will present proposed responses to a series of findings or recommendations made as part of the Department of Auditor General (DAG) and Independent Fiduciary Services' (IFS) respective performance audit and fiduciary review. A copy of these proposed responses is attached hereto as Exhibit A. This is part of staff's continuing efforts to appropriately respond to and resolve the DAG and IFS findings and recommendations.

Background

As many of you are aware, DAG and IFS, for a seventeen-month period beginning April 25, 2005, respectively, conducted a performance audit and fiduciary review of PSERS' investment operations. The Board accepted the results of both the DAG performance audit, which includes IFS' supporting fiduciary review (Report I) and the IFS fiduciary review (Report II) on October 27, 2006. Copies of both reports are available on the Board's website.

In their respective performance audit and fiduciary review reports, both DAG and IFS made a series of findings or recommendations to improve PSERS' investment operations. In the case of the DAG performance audit there were 15 specific findings, including three that required no action by PSERS, as the audited processes were deemed satisfactory. IFS made 45 recommendations in its support role to the DAG performance audit and 57 recommendations as a consequence of its independent fiduciary review, for a total of 102 recommendations in its two reports. Included in IFS' total recommendations was one where no action was required, as the reviewed process was deemed satisfactory.

PSERS provided a written response to each of the 117 findings or recommendations, which responses were included in the final DAG performance audit and IFS fiduciary review reports, approved by the Board. Some of these responses indicated that the issue in question, in either the finding or recommendation, had been already resolved. Other comments indicated PSERS' plans to resolve the findings or recommendations. Moreover, since the Board's acceptance of the DAG and IFS reports, PSERS has been diligently working to address the various findings and recommendations, and has recorded its progress on two separate matrixes.

Progress Matrixes

The first set of matrixes, one for the DAG performance audit and one for the IFS performance review, recorded PSERS' progress as of March 1, 2007. Both these matrixes were updated as of October 15, 2007. Both the initial and updated matrixes for each report have been posted to the Board's website. Copies will also be available at the Audit/Budget Committee's meeting on December 12, 2007.

As of October 15, 2007 the status of the DAG findings were as follows:

Department of Auditor General's 2006 Performance Audit Findings Matrix

Number of Findings:	15
Number of Findings Resolved:	9
Number of Findings In Process:	2
Number of Findings Pending Resolution:	<u>4</u>
Total.....	15

As of October 15, 2007 the status of the IFS recommendations were as follows:

Report I—Supplement to Department of Auditor General's Performance Audit

Number of Recommendations:	45
Number of Recommendations Resolved:	29
Number of Recommendations In Process:	5

Number of Recommendations Pending Resolution:	<u>11</u>
Total.....	45

Report II—IFS’ 2006 Independent Performance Review

Number of Recommendations:	57
Number of Recommendations Resolved:	44
Number of Recommendations In Process:	4
Number of Recommendations Pending Resolution:	<u>9</u>
Total.....	57

Additional Proposed Responses

In a further effort to resolve some of the remaining outstanding items from the DAG performance audit and IFS fiduciary review, staff has selected a series of findings and recommendations for the Committee’s consideration and action. These, together with staff’s proposed responses to them broken out by reports, (DAG performance audit, IFS Report I and II), are attached hereto as Exhibit A. If the Committee concurs with staff’s proposed disposition of these issues, they will be presented to the Board at its meeting on January 25, 2008, with the Committee’s recommendation for approval. A proposed resolution to that effect is also attached for your consideration. At the Committee’s meeting, I will be prepared to review each response and answer any questions you may have. As for the remaining findings and recommendations, they will be scheduled for Board action as time permits.

If you have any questions concerning the above, please feel free to contact me.

Exhibit A

Department of Auditor General's 2006 Performance Audit Findings

Findings/Recommendations	PSERS' Initial Response	Status and Proposed Response
<p>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.</p> <p>Recommendation:</p> <p>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</p>	<p>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, <i>inter alia</i>, with both the Commonwealth's personnel standards and the enterprise requirements governing PSERS business continuity plans and information technology infrastructure/operations.</p>	<p>3/01/2007: The Board will review this finding and recommendation at its next available meeting in calendar year 2007.</p> <p>October 15, 2007: No change in status.</p> <p><u>Proposed Response:</u> In view PSERS' extensive contacts and good working relationship with OA, both at the Board and staff level, the Board does not see the need at this time to hold regularly scheduled meetings with OA to discuss issues that may arise. It prefers instead to have staff arrange meetings with OA on an ad hoc basis as issues develop. This practice has worked well in the past and continues to do so now, as recently illustrated by PSERS' discussion with OA of the application of Executive Order 2004-8, as amended, to PSERS' Chief Technology Officer. Similarly, with respect to a specific liaison to OA, for any issue that would require Board notice or action, that person is the Executive Director. As a consequence, this matter is deemed resolved.</p>
<p>Finding 2.2: The Office Of General Counsel (OGC) On The Whole Appears To Present No Impediments That Hamper PSERS' Independence To Make Investments Or Its Mission.</p> <p>Recommendation: We recommend the following:</p>	<p>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</p>	<p>3/01/2007: The Board will consider this finding and the accompanying recommendations at its next available meeting in calendar year 2007.</p> <p>October 15, 2007: No change in status.</p>

Exhibit A

<p>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.</p> <p>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 the 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.</p>	<p>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.</p>	<p><u>Proposed Response:</u> After further review and consideration of the Board's initial response and the continuing good working relationship between PSERS and OGC, no other action is required at this time. Therefore this matter is deemed resolved.</p>
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Exhibit A

Report I—Supplement to Department of Auditor General’s Performance Audit

Recommendations	PSERS’ Initial Response	Status and Proposed Response
<p>I-A-5: The Board should develop an Audit Committee separate from the Budget Committee.</p>	<p>The Board will consider this recommendation.</p>	<p>3/01/2007: This recommendation will be discussed as part of the Board development of a formal statement of governance principles for PSERS as recommended in finding I-A-1 above.</p> <p>October 15, 2007: No change in status.</p> <p>Proposed Response: The Board agrees with IFS’ general concern that a single committee should not have authority to both develop a budget and monitor compliance with it. There is an inherent conflict of interest in that governance structure. After further consideration, however, the Board does not see the need to create separate audit and budget committees. In practice the current Audit/Budget Committee (Committee) only acts as a Budget Committee when it approves PSERS’ annual administrative budget and directed commission budgets in September. At all other times, the Committee generally acts as an Audit Committee. In the case of the administrative budget, staff is the party charged with the responsibility of preparing the two budgets, not the Committee. Moreover, primary oversight on staff’s adherence to the administrative budget rests with the Governor’s Office of the Budget, not the Committee. As for the Health Option Program and Premium Assistance budgets, they are again developed by staff and</p>

Exhibit A

		<p>recommended for approval by the Board's Health Care Committee. Here, primary oversight of PSERS' health care related budgets would rest with the Committee. As a consequence of the above, the Board believes that a conflict does not exist with the Audit/Budget Committee. Thus this matter is deemed resolved.</p>
<p>I-C-2: 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.</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 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 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.</p>	<p>3/01/2007: The Board will review this recommendation at its next available meeting in calendar year 2007.</p> <p>October 15, 2007: No change in status.</p> <p><u>Proposed Response:</u> After further review and consideration of the Board's initial response and the continuing good working relationship between PSERS and OGC, no other action is required at this time. Therefore this matter is deemed resolved. See response to II-G-4.</p>

Exhibit A

Report II—IFS' 2006 Independent Performance Review

Recommendations	PSERS' Initial Response	Status and Proposed Response
<p>II-G-4: As an alternative to granting independent authority to the Board to retain its own legal counsel, we recommend the execution of a memorandum of understanding between PSERS, the Office of General Counsel and the Office of Attorney General that would permit the Board, subject to the approval of the Office of General Counsel, to retain its own fiduciary counsel (pursuant to predetermined selection criteria regarding experience and independence from the Commonwealth) for the purpose of providing PSERS with independent legal advice and when necessary, subject to the approval of the Office of General Counsel also permit the Board to obtain conflicts counsel.</p>	<p>The Board will consider this recommendation. Although this is a different recommendation than the previous recommendation calling for an MOU permitting the Board to retain its own counsel in the event of a conflict of interest, the Board's comments there are equally applicable here with respect to an MOU for fiduciary counsel.</p>	<p>3/01/2007: The Board will review this recommendation at its next available meeting in calendar year 2007.</p> <p>October 15, 2007: No change in status.</p> <p><u>Proposed Response:</u> After further review and consideration of the Board's initial response and the continuing good working relationship between PSERS and OGC, no other action is required at this time. Therefore this matter is deemed resolved. See response to I-C-2.</p>