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Missouri State Employees' Retirement System

December 2010

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YELLOW SHEET

Findings in the audit of Missouri State Employees' Retirement System

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Salary Issues

The Missouri State Employees' Retirement System (system) Board of Trustees (Board) provides its employees significant pay raises and lump-sum incentive payments. The Board's three system-wide compensation programs (market-based salary adjustments, cost-of-living salary adjustments, and incentive compensation) provide additional compensation over and above promotion or probationary pay increases. As a result, system salary and incentive payments have increased significantly, from $4.4 million in fiscal year 2006 to $5.8 million (32 percent) in fiscal year 2010. Effective fiscal year 2011, the Board discontinued the operations staff incentive program, modified the investment staff incentive program, and provided employees with salary increases based on the amount of incentive payments they would no longer receive.

Travel Expenditures

Travel expenses are incurred for various purposes including Board meetings, Board member and employee training, conferences, retiree seminars, and due diligence monitoring visits. Travel expenses totaled approximately $1 million during the 3 years ended June 30, 2009. As noted in the prior audit report, although the Board has established general policies for Board member and employee reimbursement of travel expenses, the policies do not provide limits on the amounts that will be reimbursed for certain travel expenses. Our review noted instances where lodging and meal costs appeared excessive and/or exceeded federal employee per diem maximums established by the federal government. We also noted instances where Board members and employees rented vehicles when a more economical means of travel, such as a shuttle, cab, or shared rental vehicle, could possibly have been used, and some rental car reimbursements exceeded limits per the Board's travel policies. Adequate procedures for monitoring Board member travel expenses have not been established and some Board member travel expenses were not allowed by policy. In addition, the costs associated with the Board's annual educational conference appear excessive.

Gifts and Travel Expenses from Third Parties

As similarly noted in the prior audit report, the Board has not established a system for reporting and monitoring gifts and paid travel expenses accepted by Board members and employees.

Missouri State Employees' Retirement System
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SUSAN MONTEE, JD, CPA
Missouri State Auditor

Honorable Jeremiah W. (Jay) Nixon, Governor
and
Board of Trustees
and
Gary Findlay, Executive Director
Missouri State Employees' Retirement System
Jefferson City, Missouri

The State Auditor is required under Section 104.480.4, RSMo, to review the audits of the Missouri State Employees' Retirement System. The system engaged Williams Keepers LLC, Certified Public Accountants (CPAs), to audit the system's financial statements for the years ended June 30, 2009, 2008, and 2007. We reviewed the reports and substantiating working papers of the CPA firm and performed other procedures that we considered necessary in the circumstances. The scope of our audit included, but was not necessarily limited to, the years ended June 30, 2009, 2008, and 2007. The objectives of our audit were to:

1. Evaluate the system's internal controls over significant management and financial functions.

2. Evaluate the system's compliance with certain legal provisions.

3. Evaluate the economy and efficiency of certain management practices and operations.

Our methodology included reviewing minutes of meetings, written policies and procedures, financial records, and other pertinent documents; interviewing various personnel of the system, as well as certain external parties; testing selected transactions; and analyzing comparative data obtained from the system.

We obtained an understanding of internal controls that are significant within the context of the audit objectives and assessed whether such controls have been properly designed and placed in operation. We also tested certain of those controls to obtain evidence regarding the effectiveness of their design and operation. However, providing an opinion on the effectiveness of internal controls was not an objective of our audit and accordingly, we do not express such an opinion.

We obtained an understanding of legal provisions that are significant within the context of the audit objectives, and we assessed the risk that illegal acts, including fraud, and violations of contract or other legal provisions could occur. Based on that risk assessment, we designed and performed procedures to provide reasonable assurance of detecting instances of noncompliance significant to those provisions.

However, providing an opinion on compliance with those provisions was not an objective of our audit and accordingly, we do not express such an opinion. Abuse, which refers to behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary given the facts and circumstances, does not necessarily involve noncompliance with legal provisions. Because the determination of abuse is subjective, our audit is not required to provide reasonable assurance of detecting abuse.

We conducted our audit in accordance with the standards applicable to performance audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform our audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides such a basis.

The accompanying Organization and Statistical Information is presented for informational purposes. This information was obtained from the system's management and was not subjected to the procedures applied in our audit of the system.

The accompanying Management Advisory Report presents our findings arising from our audit of the Missouri State Employees' Retirement System.

Susan Montee, JD, CPA
State Auditor

The following auditors participated in the preparation of this report:

Assistant Director of Audits:	Douglas Porting, CPA, CFE
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Missouri State Employees' Retirement System
Management Advisory Report
State Auditor's Findings

1. Salary Issues

The Missouri State Employees' Retirement System (system) Board of Trustees (Board) provides its employees significant pay raises and lump-sum incentive payments. Although our prior audit report questioned the necessity for providing such payments, the Board continued its three system-wide compensation programs (market-based salary adjustments, cost-of-living (COLA) salary adjustments, and incentive compensation) which provide additional compensation over and above promotion or probationary pay increases.

System salary and incentive payments have increased from $4.4 million in fiscal year 2006 to $5.8 million (32 percent) in fiscal year 2010. Pay increases and incentive payments awarded to the system's approximately 15 investment employees and 60 operations employees through the three compensation programs during the 4 years ended June 30, 2010, are noted in the table below:

		Year Ended June 30,			
Compensation Increases (1)		2010	2009	2008	2007
Market-based salary adjustments					
Investment staff	$	45,000	0	155,500	0
Operations staff		17,400	115,000	41,200	0
Total market-based salary adjustments		62,400	115,000	196,700	0
COLA salary adjustments					
All staff		134,000	104,700	92,100	92,200
Incentive payments					
Investment staff		242,900	190,400	165,000	128,000
Operations staff		147,000	157,400	159,000	148,000
Total incentive payments		389,900	347,800	324,000	276,000
Total Compensation Increases	$	586,300	567,500	612,800	368,200

(1) Excludes salary adjustments and incentive payments provided to the Executive Director and the Chief Investment Officer (CIO) whose compensation is provided in employment contracts (see Organization and Statistical Information).

Compensation programs

For a number of years, the Board has increased employee salaries through market-based salary adjustments. The market-based adjustments have occurred annually beginning in fiscal year 2008 and every 2 years previously. The market-based adjustments are determined through a process performed by system personnel utilizing two external salary studies which include employees of public retirement systems nationwide and organizations in the Kansas City, Missouri region. The fiscal year 2011 salary adjustment process was handled differently as noted below.

Employees are also provided an annual COLA, similar to that provided system retirees and survivors, in years when there is an increase in the consumer price index. System employees indicated the COLA is applied to salaries after market-based salary adjustments because the salary studies supporting the adjustments are a year old.

Prior to fiscal year 2011, the Board utilized a performance incentive compensation program which applied to all staff; however, effective July 1, 2010, only investment staff remain eligible for incentive program payments. The investment employee incentive program provides investment professionals and investment operations employees an annual incentive payment of up to 20 percent and 10 percent, respectively, of the employee's salary if certain benchmarks are met. The discontinued operations employee incentive program provided all operations staff an annual incentive payment of up to 10 percent of the employee's salary based on various quantitative and qualitative measures. An operations employee received an incentive of 4 percent of their salary if the system met its performance objectives as measured by an external evaluation, and up to an additional 6 percent based on accomplishment of individual performance goals, as evaluated by the employee's supervisor. During the 3 years ended June 30, 2009, incentive payments of operations employees averaged 5.5 percent of their salaries.

Effective fiscal year 2011, the Board revised the performance incentive programs, including the discontinuation of incentive payments for operations staff and a modification and temporary hold on the investment staff incentive program. Effective fiscal year 2011, employees were provided salary increases based on the amount of incentive payments they would no longer receive.

Fiscal year 2011 salary adjustments

During January through June 2010, the Board evaluated alternative ways to provide similar compensation to its employees without continuing to utilize performance incentive compensation. The Board established a compensation committee and contracted with a professional salary consultant to perform a compensation study utilizing market data and provide recommendations establishing compensation increases. The Board required that the salary consultant's "recommendations should not result in a reduction in total cash compensation relative to what was provided by the previous pay-for-performance plan."

The salary consultant concluded system employees' pay was below market, and provided the Board with several alternatives for compensating employees. At the direction of the committee, the consultant provided options for incorporating various percentages (e.g., 50 to 100 percent) of the employees' previous incentive potential into their base salaries. In June 2010, the Board voted to continue a modified investment staff incentive compensation program, but discontinue the operations staff incentive compensation program. Based on the consultant's recommendations, the

Board voted to award raises to operations staff equal to 90 percent of each employee's average incentive payment rate over the last 3 years, and to investment staff equal to 50 percent of each employee's average incentive payment rate over the last 4 years. These salary increases were awarded effective July 1, 2010, and totaled $160,244 and $133,485 for operations and investment staff, respectively. According to Board meeting minutes, the investment staff salary increases were necessary for two reasons: 1) to mitigate lost pay due to a 6-month temporary hold on the investment staff incentive program and 2) staff will probably not receive incentive payments in some years under the modified incentive program.

Necessity for significant salary increases and incentive payments

Section 104.500, RSMo, gives the Board exclusive jurisdiction to set employee compensation. System officials indicated they believe the continued pay increases are necessary to attract and retain highly qualified and competent staff; and the system's success, which is measured by factors such as investment returns, service quality, and cost effectiveness, is due to the system's highly qualified staff. System officials also indicated they believe rewarding system employees with salary increases and incentive payments has saved the state money due to higher investment returns and lower administrative costs than its peers. Each year, the system's performance is measured against other similar public retirement systems nationwide through participation in evaluations performed by an external consulting firm. In recent external evaluations, the system ranked above many of its peers in investment returns and customer service, and its administrative costs were lower than its peers (on average). Although documentation supporting the calculations of the various salary increases and incentive payments was generally sufficient, the frequency and need for all of these increases and payments was not clear. While the salary adjustments and incentive payments might aid in attracting and retaining employees for some key and specialized positions, it is unclear whether all of the various compensation increases are necessary for retaining all system employees.

Recommendation

The Board of Trustees again re-evaluate its compensation programs and reconsider the need to apply all compensation programs to all employees, regardless of their position.

Auditee's Response

The Executive Director, as directed by the Board of Trustees, provided the following response:

*This recommendation is a little confusing in that I think it should be clear to your staff, based on the amount of time they spent on this project and the amount of my staffs' time they consumed, that "all compensation programs are **not** being applied to all employees, regardless of their position." However, given that your staff raised the issue in a very superficial way, I believe I am obligated to elaborate on what is involved in the identification and implementation of best practices in the industry with respect to* *efficiency, effectiveness and excellence in performance in which compensation is a key component.*

There are two general paths the members of a retirement system board of trustees can follow in determining how to carry out their responsibilities for the administration of a retirement plan and the implementation of policies established by state law. One is to decide to be "average." It is noteworthy that there is a significant element of safety in going the average route. After all, by being average, many excuses are available for deflecting blame and rationalizing mediocrity, with the party line being, "that's just the way things are – we're just like everyone else." Rarely will anyone be criticized for being average or, as Warren Buffet said,"…lemmings as a class may be derided but never does an individual lemming get criticized." The other approach is to identify the means of pursuing excellence, even when that results in departing from the mainstream. It is this "path less followed" that has set the direction for the *Missouri State Employees' Retirement System (MOSERS) over the years, with the overarching consideration being that mediocrity is unacceptable. Before setting out on this new journey in the mid 1990s, the MOSERS Board solicited the advice of internationally recognized authorities on board governance generally and on the management of public employee retirement systems specifically. While there were a range of opinions examined, the two most influential in developing the MOSERS business model were the views of Dr. John Carver, author of "Boards that Make a Difference," and Keith Ambachtsheer, author of "Pension Fund Excellence – Creating Value for Stakeholders."*

In his October 2010 newsletter Mr. Ambachtsheer identified the following five success drivers of pension institutions: Aligned interests, good governance, sensible investment beliefs, right scaled (large enough to achieve economies of scale), and competitive compensation. Over the years the board has devoted considerable time and attention to addressing each of these drivers. Over the past 18 months the board focused on the competitive compensation driver, with assistance from independent experts in the field, and adopted a significant number of modifications to the pay plan previously in place, but that continue to stress the importance of excellence in performance.

At the highest level, the system's performance objectives are to achieve excellence in risk adjusted investment return and to deliver excellence in cost constrained customer service.

With respect to investment return, performance at MOSERS is assessed over protracted periods to keep short-term thinking from overly influencing decision making. The following schedule illustrates long-term performance relative to benchmarks established by the board of trustees and relative to the universe of large state-wide public retirement systems.

Portfolio vs. Benchmark & Peers – 6/30/2010

	5 Year	10 Year	15 year
MOSERS	4.46%	4.88%	7.98%
Benchmark	2.76%	2.64%	6.69%
Value Added	1.70%	2.24%	1.29%
Value Added Dollars	$587 M	$1.61 B	$1.21 B
Average Public Fund*	2.76%	2.98%	6.70%
Public Fund Rank*	1st	1st	1st

*Statewide Public Fund Universe 6/30/10 (52 funds reporting)

MOSERS

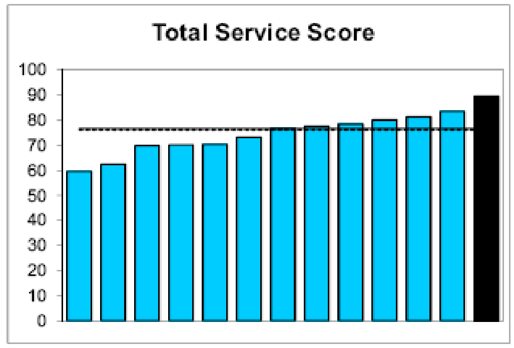
Looking at MOSERS' assets under management for the last five years, performance relative to both the MOSERS benchmark and the average of statewide public retirement funds nationally, added $587 million in value. Since our only sources of revenue are contributions from the state (the taxpayers) and investment earnings, MOSERS' performance relative to the average fund saved the taxpayers $587 million and produced a like amount of retirement benefit security for the system's members. These achievements are net of all external and internal costs associated with the system's investment program, including staff compensation and staff travel.

With respect to administrative functions, outcomes are assessed and reported by CEM Benchmarking, Inc. on the basis of a multiplicity of performance measures. The objective is top tier performance at below median cost. The following sets of charts from the most recent CEM report to the board of trustees illustrate what has been happening at MOSERS with respect to both service and cost.

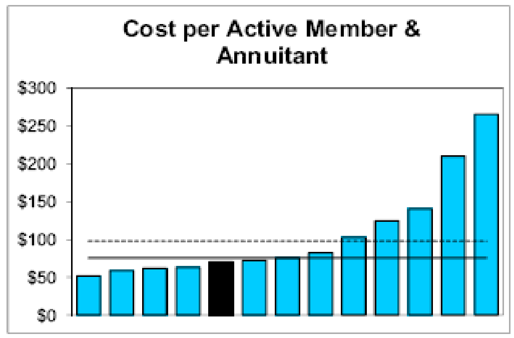
Key Takeaways

1. Your Total Service Score of 90 was above the peer median of 77 and was the highest in the peer group.

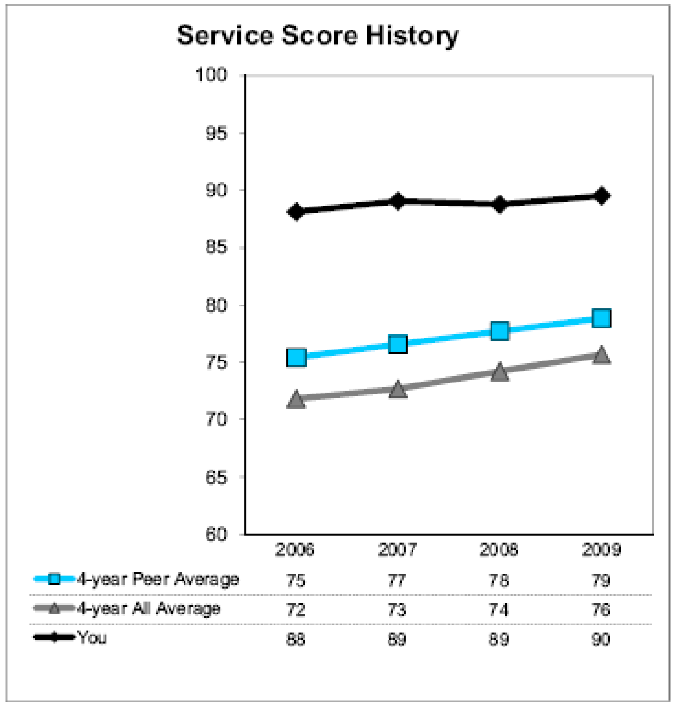
- You have increased your already high level of service over the past 4 years while maintaining your cost at $70 per Active Member and Annuitant.



2. Your Total Cost of $70 per Active Member & Annuitant was below the peer median of $75.



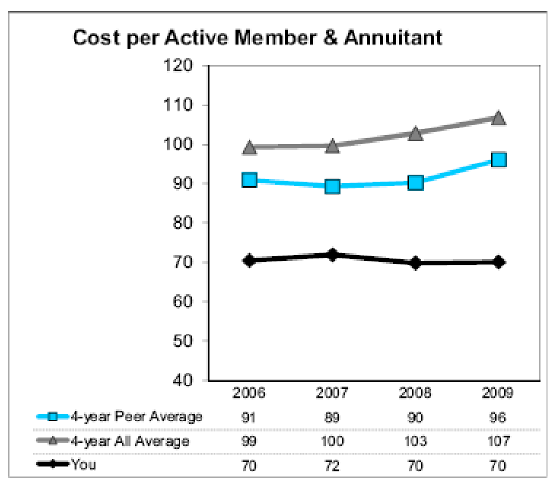
Service Trends



The 4-year peer and all averages are based on those systems that have provided 4 consecutive years of data (8 of your 13 peers, 41 of the 73 total participants)

Cost Trends

- Costs increased 2.5% per annum for the average 4-year participant.
- Your costs have remained stable over the same 4-year period.



The 4-year peer and all averages are based on those systems that have provided 4 consecutive years of data (8 of your 13 peers, 41 of the 73 total participants)

These are the products of the implementation of a complete business model targeted at the pursuit of excellence. As mentioned by Mr. Ambachtsheer, all of the drivers of success are important components of the desired outcome, including the compensation package. As with all aspects of the system's operation, the board members, in their fiduciary capacity, have the duty to monitor and make adjustments deemed necessary and appropriate. The board will continue to carry out that responsibility in the best interest of all stakeholders.

Auditor's Comment

While the results of each compensation program may not have generated a pay increase for each employee each year, during the audit period and through June 2010, all compensation programs noted in the finding were applied to all eligible system employees, other than the Executive Director and the CIO whose salaries are determined in their employment contracts. Based on policies still in effect, it appears the system intends to continue to apply all compensation programs to all eligible employees, with the exception of the operations employee incentive program which was discontinued in July 2010.

2. Travel Expenditures

Improvements to the system's travel policies and procedures are needed.

Travel expenses are incurred for various purposes including Board meetings, Board member and employee training, conferences, retiree seminars, and due diligence monitoring visits. Costs associated with system travel are most commonly paid by Board members or employees and reimbursed by the system, but can also be charged to system credit cards or paid directly to vendors. Travel expenditures totaled approximately $1 million during the 3 years ended June 30, 2009. A significant portion of system travel expenditures are related to due diligence trips to monitor the system's external service providers. One to two investment staff (and sometimes one or more Board members) go on approximately 70 due diligence trips per year, which are frequently to large out-of-state cities, with at least one international trip each year. To reduce travel costs, the system recently began holding some due diligence meetings in St. Louis, Missouri, requiring that representatives from out-of-state investment managers travel to the meetings.

We reviewed 30 Board member and employee expense reimbursements and 2 credit card statements containing travel expenses which collectively totaled $39,700, or approximately 4 percent of travel expenditures during the 3 years ended June 30, 2009. Of these travel expenditures, approximately $12,400 was associated with four due diligence trips, and approximately $12,500 was associated with a Board educational conference.

2.1 Lodging and meals

Our review noted instances where lodging and meal costs appeared excessive. The employee travel policy provides that staff should use good judgment when choosing a hotel, taking into consideration cost, proximity to meetings, transportation costs, etc., and requires a documented explanation when a single meal expense exceeds $50; however, the policy does not include limits or guidelines for these expenses.

We noted instances where meal and lodging costs paid by the system exceeded Continental United States (CONUS) and foreign per diem rates (federal employee per diem maximums, established by the U.S. General Services Administration and Department of State, frequently used by governmental agencies as travel reimbursement guidelines). Lodging costs exceeded CONUS and/or foreign per diem rates for 3 of 15 expense reimbursements reviewed containing lodging costs and 3 of the 7 credit card lodging charges reviewed. CONUS per diem rates were exceeded for meals reimbursed on 4 of 20 expense reimbursements reviewed containing meal costs.

For example, for a December 2008 due diligence trip to Los Angeles, California, lodging costs of $225 per night were reimbursed to two employees, when the CONUS rate was $128. For a September 2008 due diligence trip to New York, New York, lodging charges of $339 per night were made to a system credit card, when the CONUS rate was $311 per night. The investment operations employee responsible for making lodging arrangements for the due diligence trips indicated she utilizes a travel website to identify and compare hotels, and to book hotel reservations. She stated she considers factors such as price, proximity to the meeting(s), safety, and cleanliness when selecting hotels; however, documentation of these comparisons and considerations, including justification for the hotel selected, is not prepared and maintained.

In addition, for the December 2008 Los Angeles trip, the employees were reimbursed $22 and $19 for breakfast, when the CONUS rate was $12. Also, a Board member was reimbursed $32 and $49 for dinners during an August 2008 trip to a conference near Salt Lake City, Utah, when the CONUS rate was $26 and $31, respectively. Although the Board has established general policies for Board member and employee reimbursement of travel expenses, the policies do not provide limits on the amounts that will be reimbursed for certain travel expenses. System officials indicated they believe their current travel policies are sufficient, and that CONUS and foreign per diem rates should not be used as an absolute limit because there are other factors to consider when scheduling travel. Limits for meal and lodging expenses, such as CONUS and foreign per diem rates, regardless of the method of payment, could help ensure such payments are reasonable. Documentation should be maintained to support any travel expenses which exceed the established limits.

A similar condition was noted in our prior audit report.

2.2 Rental Vehicles

Board members and employees rented vehicles while attending out-of-state conferences when a more economical means of travel, such as a shuttle, cab, or shared rental vehicle, could possibly have been used. In addition, some Board member and employee reimbursements for rental cars exceeded reimbursement limits per the Board's travel policies. On a trip to a conference near Salt Lake City, Utah, in August 2008, each of the two Board members and the Executive Director were reimbursed for a rental vehicle. The three individuals stayed at the resort in which the conference was held and their only documented business transportation need was to travel to and from the airport. A shuttle was available to transport conference attendees to and from the airport. The system reimbursed all three individuals the entire cost of renting full-size cars and an SUV, when the Board's travel policies limit reimbursement to the cost of a mid-size vehicle. These individuals were reimbursed $657, $252, and $395 for rental vehicles and fuel, respectively. Although the Board's travel policies address renting vehicles, the policies do not require cost effectiveness of the various travel options be evaluated before renting a vehicle. Such a requirement would help ensure the system incurs vehicle rental fees only when necessary.

2.3 Annual educational conference

Costs associated with the Board's annual educational conference appear excessive. The Board holds a 1 1/2 day educational conference out of town each year for Board members and certain system employees. Our review of the costs, totaling approximately $12,500 for the July 2008 educational conference, noted the following:

- Because the conference was held in St. Charles, Missouri, which is 115 miles from the system office in Jefferson City, the system paid travel expenses for all 16 employees and 9 Board members who attended the conference. The system paid the hotel where the conference was held approximately $10,500 for rooms and meals. Most of the attendees stayed 1 or 2 nights and participated in the three meals provided during the conference.
- Nineteen of the 25 employees and Board members received expense reimbursements totaling approximately $2,000 for travel costs, including mileage to and from the conference, additional meals, and hotel internet access.
- While some participants carpooled to St. Charles, most participants (19 of 25, or 76 percent) incurred driving expenses: 9 employees and 5 Board members were reimbursed mileage, 1 Board member rented a vehicle, and 4 employees drove system-owned vehicles.
- Although the system solicited bids for the hotel/meeting facility and selected one of the lowest bids, the system paid $149 per night per person for lodging, $37 and $22 per person for lunches, and $48 per person for dinner.

System officials indicated a primary purpose of the educational conference is to provide board member education as required by Section 105.666, RSMo. System officials indicated the conference is held out of town rather than a more local location because of the benefits of being away from the office, availability of better conference facilities, and convenience for the conference speakers. Although the system typically invites outside speakers to the conferences, no outside speakers attended the July 2008 conference. The Board should evaluate the costs of the educational conferences and consider implementing more cost-effective measures, such as holding the conference at a more local location to reduce travel costs, and requiring that employees carpool, if applicable.

2.4 Monitoring Board member travel expenditures

Some Board member travel expenses were not allowed by policy. For each of the three trips reviewed for one Board member, we noted instances where travel expenses exceeded those allowed by the Board member travel policy, including payment of personal travel expenses incurred before or after the conferences or meetings the Board member attended. The expense reimbursement documentation for these three trips contained no explanation or justification for claiming these additional travel expenses.

For the 2008 trip to the conference near Salt Lake City, Utah, the Board member was reimbursed travel expenses (meals, lodging, rental vehicle and fuel, and airport parking) during the period July 30 to August 7 when the conference was held from August 1 to August 6. For the same conference, another Board member and the Executive Director were reimbursed expenses on 2 and 3 fewer days, respectively. In addition, the system paid costs incurred by the Board member for a rental vehicle and lodging for an extra day after the July 2008 Board educational conference. While all other Board members and employees who attended the conference incurred expenses for 1 or 2 days, this Board member incurred expenses for 3 days.

The Board member travel policy provides that reimbursement for travel expenses is limited to those expenses authorized and essential to the transaction of official system business and that expenses incurred for the sole benefit of a system official or employee will not be reimbursed. Although Board member travel expenses are reviewed by the Executive Director and the Board's Secretary, these items were not questioned. System officials indicated the Board member is frequently reimbursed travel expenses for an additional day(s) when traveling on system business. Travel expenses should be limited to those necessary to conduct official system business. Procedures should be established to properly review Board member travel expenses and to ensure adequate supporting documentation is maintained to justify any expenses which exceed those allowed by the policy.

Recommendations

The Board of Trustees:

2.1 Establish reasonable maximum rates for all meal and lodging costs. The reasons necessitating rates exceeding those established guidelines should be documented.

2.2 Establish guidelines for determining the most economical method of transportation and ensure reimbursements comply with Board travel policies.

2.3 Evaluate the costs and consider ways for reducing the costs associated with the annual educational conference.

2.4 Establish procedures to properly review Board member travel expenses for compliance with the Board travel policy and ensure adequate supporting documentation is maintained to justify any expenses which exceed those allowed by the policy.

Auditee's Response

The Executive Director, as directed by the Board of Trustees, provided the following responses:

Board and staff members are very conscious of "economy" in the conduct of business. However, unlike what has been suggested in the recommendations, economy is not one dimensional as reflected only by "travel expenses." Rather, it is the composite result of "net economy" in terms of what is the most cost effective approach to accomplishing required travel, also considering the most efficient use of Board and staff time in fulfilling their fiduciary responsibilities. With that in mind, the following is offered in response to the specific audit staff recommendations.

2.1 Staff has made suggested changes to the Board travel policy. The Board will take the proposed changes under advisement.

The staff travel policy is being amended. The policy amendment will address conference hotel costs to ensure the costs are reasonable without risking the well-being of our staff and the efficient execution of their assigned tasks. The current policy requires that any meal cost that exceeds $9, $13, and $20 for breakfast, lunch, and dinner, respectively, must be supported by a written receipt. Any meal cost over $50 must be further explained to ensure the cost was appropriate under the circumstances.

While these limitations may not be consistent with the limits set by the federal government for their employee travel, we believe the limitations are reasonable and provide staff with required flexibility when traveling.

Staff believes that the modification to the policy and the current meal limits address the State Auditor's concerns noted in this section.

2.2 *Staff has made suggested changes to the Board travel policy. The Board will take the proposed changes under advisement.*

2.3 *The Board believes the annual educational conference is being held in the best location available, all things considered (including the cost of outside experts in the complex areas that must be addressed), and is being conducted at a reasonable cost.*

2.4 *Staff has made suggested changes to the Board travel policy. The Board will take the proposed changes under advisement.*

3. Gifts and Travel Expenses from Third Parties

The Board has not established a system for reporting and monitoring gifts and paid travel expenses accepted by Board members and employees.

Board members and employees periodically receive paid travel expenses (e.g., meals, lodging, and airfare) from investment managers and other third parties while attending conferences or conducting monitoring reviews. Our review of 30 expense reimbursements and 2 credit card statements found several instances where certain travel expenses were not claimed for overnight trips taken, and there was no documentation indicating how these expenses were paid. In response to our inquiries, system employees indicated these expenses were paid by third parties.

The Board member code of conduct policy, and Section 104.500, RSMo, provide that any Board member or employee accepting any gratuity, political contribution, or compensation for the purpose of influencing his action with respect to the investment of the funds of the system shall forfeit his office and be subject to other penalties prescribed by law. The system's employee conflict of interest policy prohibits employees from accepting gifts from any one source which in total exceed $200 during a year. Specific items the policy does not consider to be gifts, and which employees are allowed to accept from third parties (regardless of value) include the following:

- Food
- Beverages
- Admission to social, art, or sporting events, and activities
- Travel expenses (hotel and transportation expenses)
- Honorarium, in any form, paid to an employee in connection with making an educational presentation
- Informational material

Accepting travel expenses or other gifts, including those allowed by current policies, from entities which the system contracts with or could potentially contract with, could give the appearance of a conflict of interest. In the prior audit report, we recommended the Board re-evaluate the policies which allow the acceptance of gifts or other items of value by Board members and employees; and if determined allowable, the Board establish a system for reporting and monitoring these items. In September 2006, the Executive Director revised the employee conflict of interest policy with small changes to the list of items employees are allowed to accept from third parties and the addition of the requirement that employees obtain prior approval from the Executive Director or a Deputy Executive Director before accepting certain items from third parties. The Executive Director's response to our prior recommendation stated the revised travel policy would "require staff to document when meals or hotels are included in conference registration fees or paid by outside parties;" however, such documentation is not always maintained. In addition, although the revised employee conflict of interest policy requires prior approval from the Executive Director or a Deputy Executive Director before accepting paid travel expenses from a third party, such approval is not documented. System employees indicated prior approval is verbally given for the applicable items. Without documentation, the acceptance of these items cannot be monitored for compliance with Board policy.

The Board should establish a system for reporting and monitoring all gifts or other items received by Board members and employees from third parties. Records should document the name of the third party, their relationship to the system, expenses paid, the name of the recipient, the date, and the estimated value of the item received. These records should be periodically reviewed by the Board and staff to ensure such items are reasonable. In addition, any prior approvals required by policy should be documented.

Recommendation

The Board of Trustees establish a system for reporting and monitoring gifts or other items of value which are accepted from third parties by Board members and employees. In addition, any prior approvals required by policy should be documented.

Auditee's Response

The Executive Director, as directed by the Board of Trustees, provided the following response:

The implication here is that Board and staff members are accepting "gifts" from third parties. In reality that is not happening but we acknowledge that policies could be more specific with respect to travel expenses paid by third parties, meals provided by third parties, and educational opportunities provided by third parties. For example, as a limited partner in a private equity partnership, the partnership typically covers the travel costs of *limited partner due diligence related to participation in either annual partner meetings or advisory committee meetings. In those cases, we would be one of many limited partners and, in the vast majority of these cases, additional funds cannot be committed and withdrawals are already scheduled to take place at a specific future date. What this means is that the conflicts of interest are non-existent in these cases because the partnerships are not raising funds but simply meeting with the investors to discuss their investments. We could pay those travel expenses directly, as permitted by policy, but if we did we would effectively be paying them twice. However, we are in agreement that the policy describing this situation and the related documentation could be clearer and the board amended the governance policy at their November board meeting relating to this subject.*

Auditee's Overall Response

The Executive Director, as directed by the Board of Trustees, provided the following overall response:

In your transmittal letter the statement is made that, "We conducted our audit in accordance with the standards applicable to <u>performance audits</u> contained in Government Auditing Standards, issued by the Comptroller General of the United States." Regardless of what "performance audit" means to those engaged in auditing, I believe the public at large would reasonably conclude that your examination had something to do with an assessment of organizational performance and results of operations. Since our actual performance was not mentioned in any detail in your report, I will address it first. Then I will respond to the specific recommendations made by your staff and conclude with general observations regarding (1) the scope of your work and our voluntary participation in the process, and (2) the ways in which we have embraced independent detailed external scrutiny of our operations by individuals who are very knowledgeable about our lines of business and industry best practices.

<u>Performance</u>

<u>Investments</u>*: The focus is on long-term excellence in risk adjusted return. As will be noted later in my response, MOSERS ranked number one in performance for the last 5, 10, and 15 years in the national universe of statewide public employee retirement systems. For the last 10 years, our returns in excess of what would have been achieved by passive implementation of our asset allocation model added $1.6 billion to the fund's value – that is $1.6 billion in value added to the fund by staff implementation decisions, $1.6 billion in additional retirement income security for our members, and $1.6 billion in contributions the taxpayers will not be called on to pay. (That is over $250 in tax savings for every citizen of the state of Missouri.)*

<u>Operations</u>*: The focus is on top tier service at below median cost. As will be detailed later, we have achieved the highest level of customer service* *among our peers and, despite our size disadvantage relative to the mega-funds, we are operating at below median cost per participant. By investing in people and technology we have achieved stellar performance while running at 14% below the expected staffing level for an organization of our size and responsibilities.*

I would think the taxpayers would applaud efforts on your part to identify best practices and promote excellence in performance. I know I would certainly appreciate being made aware of achievements of state agencies and how their successful practices might be emulated.

Other General Observations

Statutory Scope of Review to be Conducted by State Auditor and Our Voluntary Compliance with the Demands of Your Office

Section 104.480.4 RSMo, reads as follows:

> *4. The board shall arrange for annual audits of the records and accounts of the system by a certified public accountant or by a firm of certified public accountants.* ***The state auditor shall examine such audits at least once every three years and report to the board and the governor.*** *(Emphasis added.)*

Your staff members maintain that your authority under general state law permits you to conduct any type of examination of our records you deem appropriate. As an attorney, I am confident you are aware that pursuant to common statutory construction, specific provisions in the law override general provisions. If the general assembly had intended you to have the authority that your representatives maintain you have, there would have been no reason for specificity in Chapter 104 regarding your assigned responsibilities which limits the scope to an examination of the independent external audits.

When I inquired as to why your office had failed to comply with the statutory requirement that the stipulated examinations be conducted every three years I was informed that your office lacked the staff capacity. I would suggest that if you limited the scope to the statutory mandate, you would be able to comply with the frequency requirement.

With that said, in the interest of transparency and cooperation, we have voluntarily made all of our records available to your staff members and devoted very significant amounts of staff time to responding to lengthy detailed inquiries. In light of our voluntary willingness to be subjected to any scrutiny you believe to be appropriate, it is disheartening to see a report on "performance" that fails to address in any detail our track record and the hundreds of millions of dollars saved by rigorous implementation of best practices.

Other Financial and Operational Scrutiny

I want to assure you that we are not offended by criticism that is constructive and based on judgments of individuals who actually have material pension industry experience in areas where informed decisions are being made. In fact, I suspect that there are very few state organizations that could match MOSERS in voluntarily subjecting themselves to the extensive external scrutiny of experts, all for the purpose of evaluating how we can continue on the path of doing it better for less, and that is a practice that will be continued. In addition to the external financial audit you are required to examine every three years, the following is a listing of some of the other examinations and reviews we have had conducted:

- *Internal audits*
- *Fiduciary audit*
- *Actuarial audits*
- *Benchmark audits*
- *Hedge fund audits*
- *IT penetration audits*
- *Internal audit peer reviews*
- *Audits of investment consultant*

It is curious that none of this was mentioned in your report since, according to the audit manager, one of the objectives your office established for your review was to provide information that would be of interest to the taxpayers. I think this extensive list of audit activity would give the taxpayers and other stakeholders some comfort that the system's resources and all aspects of the system's operations are being professionally subjected to comprehensive scrutiny.

Auditor's Comment

Audits conducted under performance audit standards can include a wide range of objectives. A comparative assessment of the system's organizational performance and results of operations was not an objective of this audit. As noted in MAR finding number 1 and the Executive Director's response, the system has contracted with external firms to perform such reviews of the system's performance and results.

Missouri State Employees' Retirement System Organization and Statistical Information

The Missouri State Employees' Retirement System (MOSERS) was created September 1, 1957, under an act of the General Assembly to provide retirement benefits to most full-time state employees not covered by other retirement plans of the state, including members of the Missouri General Assembly, elected state officials, judges, and administrative law judges and legal advisors. The system provides retirement, survivor, and disability benefits, as well as life insurance to its members. The system administers, or contracts for the administration of, three retirement plans, an insurance plan, a long-term disability plan, and a deferred compensation plan: Missouri State Employees' Plan, Judicial Plan, College and University Retirement Plan, Basic and Optional Life Insurance Plan, Long-term Disability Plan, and the Missouri State Employees' Deferred Compensation Plan.

The Missouri State Employees' Plan is a single-employer, public employee, defined benefit retirement plan administered in accordance with Chapter 104, RSMo. Within the Missouri State Employees' Plan are two benefit structures known as the MSEP (closed plan) and MSEP 2000 (new plan). On April 2, 2005, legislation terminated the Administrative Law Judges and Legal Advisors' Plan (ALJLAP) for new hires and all liabilities and assets of the ALJLAP were subsequently transferred and combined with the Missouri State Employees' Plan. As of June 30, 2009, there were 55,057 active, 17,259 terminated vested, and 31,637 retired members and beneficiaries of the Missouri State Employees' Plan. Legislation passed in July 2010 created a new tier within the MSEP 2000 Plan and the Judicial Plan for employees hired on or after January 1, 2011. These employees will be required to contribute four percent of their pay to the system, and will have certain other provisions that differ from those applicable to previously hired employees.

The Judicial Plan is a single-employer, public employee, defined benefit retirement plan administered in accordance with Chapter 476, RSMo. As of June 30, 2009, there were 397 active, 45 terminated vested, and 463 retired members and beneficiaries of the Judicial Plan.

The College and University Retirement Plan (CURP) is a defined contribution plan for education employees at regional colleges and universities in Missouri, and became effective July 1, 2002. The CURP is administered in accordance with Chapter 104, RSMo. The system contracts with an outside service provider, TIAA-CREF, to administer the plan.

The Basic and Optional Life Insurance and Long-term Disability Plans provide basic term life and long-term disability insurance to eligible members of the MSEP and MSEP 2000 (except employees of the Missouri Department of Conservation and certain state colleges and universities), members of the Judicial Plan, and certain members of the Public School Retirement System. The Basic and Optional Life Insurance Plan also provides duty-related death benefits and optional life insurance for active employees and retirees who are eligible for basic coverage. The plans are insured through The Standard Insurance Company.

Effective September 1, 2007, legislation transferred responsibility for the administration of the Missouri State Employees' Deferred Compensation Plan from the Missouri State Public Employees' Deferred Compensation Commission to the MOSERS Board of Trustees. The system contracts with an outside service provider, ING, for the plan's general administration.

Board of Trustees

The responsibility for the operation and administration of the system is vested in an 11 member Board of Trustees. This Board consists of two members of the Senate, appointed by the President Pro Tem of the Senate; two members of the House of Representatives, appointed by the Speaker of the House; two members appointed by the Governor; the State Treasurer; the Commissioner of Administration; and three other members of the retirement system, one of whom must be retired, who are elected by a plurality vote of the membership to 4-year terms. The members of the Board of Trustees as of June 30, 2009, were as follows:

Name and Title	Membership	Term Expires
Wayne Bill, Board Chair (1)	Elected (Active)	December 31, 2010
Don Martin, Vice Chair (1)	Elected (Retired)	December 31, 2010
Clint Zweifel	State Treasurer	(2)
Kelvin Simmons	Commissioner of Administration	(2)
Jason Crowell	Senator	(3)
Timothy Green	Senator	(3)
Bill Deeken	Representative	(3)
Michael Parson	Representative	(3)
Travis Morrison	Governor Appointed	(3)
David Steelman	Governor Appointed	(3)
Bob Patterson (1)	Elected (Active)	December 31, 2010

(1) Don Martin and Bob Patterson were elected Board Chair and Vice Chair, respectively, in January 2010.

(2) Term expires with office held.

(3) Serves at the pleasure of the appointing authority.

Executive Staff

Gary Findlay has served as the Executive Director since August 1, 1994. The Executive Director coordinates the daily operation of the system, contracts for professional services, and advises the Board on all matters pertaining to the system. At June 30, 2009, the system had 73 employees including the Executive Director. The executive staff and their annual compensation as of December 31, 2009, were as follows:

Name and Title	Annual Compensation (1)
Gary Findlay, Executive Director (2)	$246,312
Rick Dahl, Deputy Executive Director - Chief Investment Officer	364,309
Karen Stohlgren, Deputy Executive Director - Chief Operations Officer	138,761

(1) Includes incentive payments of $19,602, $114,000, and $8,949 for the Executive Director, Chief Investment Officer, and Chief Operations Officer, respectively. The Executive Director's employment contract, effective January 2007, provides for an annual incentive payment, as determined by the Board, not to exceed 10 percent of his salary. The Chief Investment Officer's contract, effective January 2007, provides for an annual incentive payment, up to 50 percent of his salary, if certain investment performance benchmarks are exceeded by preset levels. His contract also provides for a long-term incentive amount of up to 50 percent of his salary, if certain performance benchmarks for the 5-year period 2007 through 2011 are exceeded by preset levels. This long-term incentive amount (which totaled $354,225 as of December 31, 2009, and will only be paid if requirements are met for the entire 5-year period) will be paid after completion of the 5-year period, or will continue to be deferred if the Chief Investment Officer's employment contract is renewed.

The Executive Director and Chief Investment Officer receive annual market-based salary adjustments as outlined in their employment contracts. The Chief Operations Officer received salary adjustments and incentive payments under the employee compensation programs discussed at MAR finding number 1.

(2) In addition to base salary and incentive payments, the Executive Director's current contract provides for the purchase of 3 years of prior service credit ($15,000 per year) based on his previous public employment with the Local Government Employees Retirement System.

Additional information regarding the system's plan provisions and benefits, assets, investments, financial activities, consultants, and actuarial valuations is included in various documents and reports which are available on the system's website (www.mosers.org).