Sam M. McCall, CPA, CGFM, CIA, CGAP
City Auditor

HIGHLIGHTS

Highlights of City Auditor Report #0621, a report to the City Commission and City management.

WHY THIS AUDIT WAS DONE

As of September 30, 2005, investments of the City's defined benefit pension plan were valued at $947 million. Investments of the City's two defined contribution plans as of that date were valued at $289 million, with $59 million of that amount representing City funds invested for the purpose of accumulating sufficient assets to pay Matched Annuity Pension (MAP) Program payouts.

This audit addressed investment performance of the City's pension plans and the adequacy of the Treasurer-Clerk's oversight of the pension investment function. The objectives of the audit included (1) examining investment performance; (2) determining whether City pension investment activity was in compliance with governing laws; (3) evaluating the adequacy of the pension investment policy; (4) examining the Treasurer-Clerk's procedures and methods for monitoring investment performance and selecting external managers; (5) determining whether external managers, custodial agents, third party administrators, and consultants complied with applicable contractual terms; and (6) determining the adequacy of internal controls.

WHAT WE RECOMMEND

Adjustments should be made so that amounts invested in international securities do not exceed maximums allowed by state law for police and firefighter plans. An investment policy should be established for the defined contribution plans. Enhancements and clarifications should be made to the defined benefit plan investment policy. Changes should be made to improve monitoring and oversight of pension investment activities (e.g., earnings performance, contractual and policy requirements, reviewing and paying third parties). Better documentation should be maintained. Internal controls should be strengthened.

To view the full report, go to:
http://www.talgov.com/auditing/index.cfm
and select *Auditing Reports*, then *Reports Issued FY 2006*, then *Report #0621*.

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Audit Conducted by T. Bert Fletcher, CPA

July 10, 2006

AUDIT OF CITY PENSION INVESTMENTS

While pension investment performance has been strong, enhancements are needed to the monitoring and oversight function.

WHAT WE FOUND

Overall, the City has achieved its investment return goals established for City pension plans. As a result, the City pension plans are in sound financial condition. Pension investments were generally made in compliance with governing legal requirements. Overall, internal controls were adequate. However, areas were identified where improvements and enhancements are needed.

Legal Requirements. For the police and firefighter plans, adjustments are needed so that amounts invested in international securities do not exceed the 10% maximum allowed by state law.

Investment Policy. A formal investment policy had not been established for the defined contribution pension plans. Additionally, the investment policy for the defined benefit plan did not address internal controls and documented operational procedures.

Monitoring and Oversight. Several improvements were needed:

- Investment performance should be measured "net" of fees.
- Contracts with external managers should address policy benchmarks as well as key policy requirements.
- Better documentation should be maintained to explain and justify investment manager and fund selection decisions.
- To avoid errors of the type identified by the audit, staff should enhance their reviews of custodian invoices.
- Staff should ensure that applicable external managers bring their portfolios into compliance with City policy and contractual requirements.
- A formal process should be implemented to periodically ensure that external managers comply with key policy and contractual terms.
- Efforts should be made to improve retention and filing of key contractual documents and other records.
- Monitoring of security lending activity should ensure that earnings are accurately and properly allocated.
- Incompatible system permissions within the bank's wire transfer system should be assigned to different Treasurer-Clerk employees.
- Authorization instructions sent to the custodian and third party administrator should be periodically updated.
- Consideration should be given to increasing current insurance coverage for employee theft.
- Minutes prepared for quarterly Investment Advisory Committee meetings should be formally reviewed and approved.

PENSION INVESTMENTS

AUDIT REPORT #0621

July 10, 2006

CITY OF
TALLAHASSEE
OFFICE OF THE CITY AUDITOR

Copies of this audit report #0621 (project #0511) may be obtained from the City Auditor's web site (http://talgov.com/auditing/index.cfm), by telephone (850 / 891-8397), by FAX (850 / 891-0912), by mail or in person (City Auditor, 300 S. Adams Street, Mail Box A-22, Tallahassee, FL 32301-1731), or by e-mail (auditors@talgov.com).

Audit conducted by:
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Sam M. McCall, CPA, CGFM, CIA, CGAP, City Auditor

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PENSION INVESTMENTS

CITY OF TALLAHASSEE
OFFICE OF THE CITY AUDITOR

Sam M. McCall, CPA, CGFM, CIA, CGAP
City Auditor

Report #0621 *July 10, 2006*

Executive Summary

We reviewed pension investment performance and related oversight and administration of the pension investment function by the Treasurer-Clerk's Office.

This audit reviewed investment performance of City pension investments as well as related oversight and monitoring activities performed by the Treasurer-Clerk's Office. We also addressed compliance with governing legal requirements and the adequacy of the City's pension investment policies and procedures. Internal controls over pension investment transactions were also evaluated.

The City invests pension assets in connection with its defined benefit plan (a single retirement system with three separate benefit structures; one each for general employees, police officers, and firefighters) and its defined contribution plans (Matched Annuity Pension Program and Deferred Compensation Program). Pension investments of the defined benefit plan as of September 30, 2005, were valued at $947 million (almost $1 billion). Pension investments of the two defined contribution plans as of September 30, 2005, were valued at $289 million. Fifty-nine million of that $289 million represented City funds invested for the purpose of accumulating sufficient assets to pay Matched Annuity Pension (MAP) Program payouts.

City pension investments for the defined benefit and defined contribution programs are currently valued in excess of $1.2 billion.

Overall, we found that the City has achieved its investment return goals established for City pension plans. As a result, the City pension plans are in sound financial condition. We found:

- Over the last decade, the investment performance of the City's defined benefit plan exceeded the average and/or median performance of two separate peer groups; one group comprised of 14 similar Florida municipalities and the other group comprised of 178 public fund sponsors (i.e., various local government plans as well as some state and federal pension plans).

- Over the last decade, the investment performance of the City's defined benefit plan exceeded the investment policy benchmark, which was the rate of inflation plus four percent per year over rolling 10-year periods.

- Over the last decade, the investment performance of the City's defined benefit plan exceeded the rates of return used by actuaries in preparing reports that assist City management in establishing pension contribution rates.

Overall, the City has achieved its investment return goals established for City pension plans.

- Investment performance has placed the City's defined benefit plan in sound financial condition, as reflected in the most recently completed actuarial valuation (as of September 30, 2003) that shows the plan is fully funded with no actuarial liabilities.
- When compared to performance benchmarks, investment earnings of the funds comprising the City's defined contribution programs have been acceptable, if not strong.
- The City has a fully functioning investment advisory committee that plays an active role in assisting the Office of the Treasurer-Clerk in monitoring performance and making investment-related decisions.
- City pension investments were generally made in compliance with governing state and City legal requirements and City policy and procedures.
- The investment policy established for the City's defined benefit pension plan is generally adequate and in accordance with industry standards.

Other aspects demonstrate that the investment process has been properly managed.

- Asset allocation strategies compare favorably with similar local government pension plans within the state.
- The City uses a competitive and merit-based approach in the selection of external managers and funds.
- External managers generally invested pension funds in allowable securities and in accordance with contractual provisions.
- Overall, internal controls were adequate in regard to the initiation and execution of pension investment transactions.

However, we identified areas where improvements and enhancements are needed. Those areas include the need for (1) improved monitoring and oversight of pension investment activities (earnings performance, contractual and policy compliance, third party fees, etc.); (2) enhancements to existing policies and procedures; (3) improved documentation of certain activities and decisions in regard to City pension investments; and (4) improved internal controls over pension investment transactions.

Issues were identified where improvements and enhancements are needed.

Specific issues were identified for which recommendations for improvement were made. Those issues/recommendations include:

- For the police and firefighters pension plans, adjustments (reallocations of investments) should be made so that the amounts invested in international equities (i.e., between 10% and 15% of plan assets) do not exceed the 10% maximum allowed by state law.
- The City should establish a formal investment policy for the defined contribution pension plans.
- The City's investment policy for the defined benefit plan should be enhanced to address and require proper internal controls and documented operational procedures.

Improvements are needed in regard to monitoring and oversight of pension investments activities (e.g., earnings performance, contractual and policy requirements, reviewing and paying third party fees).

- The City's investment policy for the defined benefit plan should be modified to clarify that real estate investments are not limited to one named external manager.
- To allow for an accurate and efficient evaluation, external manager investment performance (earnings) should be measured and reported "net" of manager fees.
- Contracts with external managers should address or directly reference policy benchmarks against which their performance will be evaluated.
- Written procedures for evaluating earnings performance of pension investments should be prepared and formalized.
- Better documentation should be prepared and retained to explain and justify investment manager and fund selection decisions.
- Written procedures for the selection and hiring of external managers and funds should be prepared and formalized.
- To avoid errors of the type identified by the audit, Treasurer-Clerk staff should enhance their review of custodian invoices to ensure that fees are correctly billed and paid. Written

procedures for conducting such reviews should be established as part of this process.

Enhancements should be made to current policies and procedures.

- We found one instance where an external manager maintained $7.2 million (less than one percent of all pension investments) of the City's investment portfolio in unallowable securities. In two other instances we noted where external managers did not meet contractual limitations on or requirements for investments. Treasurer-Clerk staff should ensure that the respective external managers adjust those portfolios to bring them into compliance with City policy and contractual requirements.
- Written procedures should be developed and formalized to document the current process of paying manager fees based on manager-reported values instead of custodian-reported values when the differences in those values are not significant.
- Contracts with external managers often did not address key policy provisions and requirements (e.g., limitations and restrictions on investments).
- Efforts should be improved to retain and file key contractual documents (e.g., fee schedules) and other records necessary to properly review and approve manager fees and to review manager performance and compliance with applicable terms and provisions.

Better documentation is needed of certain activities and management decisions in regard to City pension investments.

- A formal process should be developed and implemented to periodically ensure that external managers are in compliance with key policy and contractual terms and provisions.
- Monitoring of security lending activity should be enhanced to ensure that earnings are accurately and properly allocated to the City, collateral is of the proper type, and loan earnings by category are reasonable.
- Incompatible system permissions within the bank's wire transfer system should be assigned to different employees within the Treasurer-Clerk's Office.
- Authorization instructions sent to the custodian and third party administrator should be periodically and routinely updated.

Internal controls over pension investment transactions and activities should be strengthened.

Recommendations were made to address issues identified.

- Records should be maintained to document authorizations by applicable Treasurer-Clerk staff for cash withdrawals from the custodian.

- Because of the current insurance coverage cap of $1 million per event, consideration should be given to increasing current insurance coverage for employee theft, as designated Treasurer-Clerk employees often execute wire transfers of pension funds in amounts that exceed $1 million.

- Additional steps should be taken to obtain assurance that external managers timely and properly reconcile their records and activity to the records and activity reported by the custodian.

- To clearly document and substantiate key investment decisions and discussions, minutes prepared by Treasurer-Clerk staff for the quarterly Investment Advisory Committee (IAC) meetings should be formerly reviewed and approved by Treasurer-Clerk management and the IAC.

In connection with our audit procedures conducted in relation to the pension investment function, we also became aware that Accounting Services was not performing adequate reconciliations of the City's bank account to the City's accounting records. Recommendations were made to address that issue.

We would like to acknowledge the full and complete cooperation and support of Treasurer-Clerk staff, as well as applicable staff in Accounting Services, during this audit.

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PENSION INVESTMENTS

Sam M. McCall, CPA, CGFM, CIA, CGAP
City Auditor

Report #0621 ***July 10, 2006***

Objectives

This audit addressed investment performance of the City's pension plans and the adequacy of the Treasurer-Clerk's oversight of the pension investment function.

The objectives of this audit were to: (1) examine the City's performance in achieving investment return goals for the pension plans; (2) compare the City's pension investment performance to that of other public pension plans, including similar local governments within the state; (3) determine whether the City's pension investment activity was in compliance with governing state laws and other legal requirements; (4) determine the adequacy of and compliance with the Treasurer-Clerk's pension investment policy; (5) examine the Treasurer-Clerk's procedures and methods for evaluating and monitoring pension investment performance; (6) examine the Treasurer-Clerk's process and procedures for selecting external managers and investment funds for the pension program; (7) determine whether external managers, custodial agents, third party administrators, and consultants complied with applicable contractual terms and conditions; and (8) determine the adequacy of internal controls over execution of pension investment transactions and other aspects of the pension investment process.

Scope

Investment performance over the last decade was considered; investment activity and transactions for the most recent three-year period were evaluated.

The scope of this audit included a review of investment performance and activity for both the City defined benefit and defined contribution pension plans. Investment returns over the last decade were considered. The current investment policy and Treasurer-Clerk procedures in effect at the time of our audit fieldwork during fall 2005/winter 2006 were reviewed for purposes of completing applicable audit objectives stated above. For the most part, investment transactions and activity occurring during the three-year period July 2002 through June 2005 were evaluated, with a primary focus on activity during the one-year period July 2004 through June 2005. In a few instances, activity was reviewed through September 30, 2005.

Methodology

We reviewed processes and records, interviewed Treasurer-Clerk staff, obtained comparison data from the State Division of Retirement and State Board of Administration, corresponded with applicable external parties, and performed various tests and analyses.

To address the stated audit objectives, we reviewed procedures, processes, records, and reports within the Treasurer-Clerk's Office. We interviewed Treasurer-Clerk staff assigned duties relating to the pension investment function. In addition, we visited the Bureau of Local Government within the Division of Retirement, State of Florida, and obtained pension investment data for similar local governments for comparative purposes. Similarly, policies were obtained from the State Board of Administration (SBA, which is responsible for investing state pension assets) relating to selecting and evaluating investment managers. Those SBA policies were used in a comparative evaluation of the City's procedures. We also corresponded with the City's investment consultant and custodial agent as needed to obtain information and clarification of our understandings of information. Various tests, comparisons, and analyses of data and information were performed for the purposes of completing the stated audit objectives.

This audit was conducted in accordance with Generally Accepted Government Auditing Standards and Standards for the Professional Practice of Internal Auditing.

Background

General. The City provides both defined benefit and defined contribution plans for City employees. The successful investment of assets contributed to those plans is critical to ensuring that sufficient funds are available to pay the designed benefits intended under both plan types.

Pension investments are made through both the City's defined benefit and defined contribution pension plans.

Under a defined benefit plan, the government invests assets so as to provide a fixed income to eligible retired employees. That fixed income (or *defined benefit*) is based on a formula that normally takes into consideration factors including an employee's years of service and average salary during his/her last years of work. (This calculated fixed pension generally can be adjusted annually thereafter by cost-of-living adjustments.) The basic investment objective for a defined benefit plan is to accumulate assets that are sufficient to fund those "fixed" pension payments as they come due. (NOTE: The City has a single retirement defined benefit plan with three separate structures, one each for general employees, police, and firefighters. Assets are commingled and invested. Each separate structure owns a pro rata share of the total investment portfolio.)

Under a defined contribution plan, the government and/or its employees contribute a fixed amount (or *defined contribution*) of funds to individual employee retirement accounts each designated period (i.e., pay period). The contribution is fixed and based on a percentage of the employee's current salary. The basic investment objective for a defined contribution plan is for each participant account to accumulate sufficient assets (through contributions and earnings on those contributions) to provide for a supplemental retirement income. As described in a subsequent paragraph, the City has two separate defined contribution plans. (NOTE: City of Tallahassee regular employees do not participate in the U.S Social Security Administration Program. Accordingly, social security taxes are not withheld from their earnings and they do not earn and receive social security benefits based on their City employment.)

Pension assets should be invested prudently and in accordance with other basic principals regarding safety, liquidity, yield, diversification, safekeeping, accounting, performance evaluation, and internal controls.

Pension Investment Principles. There are several basic investment principles that should be followed to meet the objective of accumulating sufficient assets for employees' retirement. First and foremost, is that the government charged with investing public funds for employee pension plans must perform that function in a prudent manner. Performing in a prudent manner means that the government is expected to protect the beneficiaries' (employees') interests by exercising due diligence in the selection of investment options and by governing the pension plan through documented policies and procedures. Other basic principles, include:

- Safety of Principal – Assets should be invested in a manner so that there is no principal loss of funds. (Note: While some fluctuations in principal values are expected, especially for equity investments, investment values over the long haul should grow and not decline.)

- Liquidity – Sufficient liquidity must be maintained in order to pay pension benefits to retiring employees as they come due (and to pay plan administrative fees).

- Yield (or rate of return) – Earnings should be adequate to accumulate sufficient funds to pay pension benefits earned by retiring employees.

- Diversification – Investments should be diversified by instrument and type (or by category and style) so as to reduce exposure to risk. In other words, all assets should not be invested in one instrument (e.g., one particular equity) or one type of instrument (e.g., just one category of equities or one type of fixed-income instruments).

- Safekeeping and Custody – Investment assets should be adequately maintained and secured. This is often done through a contracted entity (e.g., custodial agent) other than the investing government and the entity hired to execute investment transactions (e.g., broker/dealer or external investment manager).

- Accounting and Reporting Requirements – Accounting for investments assets should be proper and accurate; periodic reports reflecting status and earnings should be prepared/received and reviewed to assist in monitoring performance.

- Performance evaluations – Performance should be periodically monitored and measured and compared against established performance expectations, such as industry benchmarks or actuarially assumed rates of return (i.e., rate of return necessary to accumulate sufficient assets to fund expected pension benefits based on identified factors used in an actuarial study).

- Internal Controls – Controls and procedures should be in place that address areas such as risk identification and mitigation, segregation of incompatible duties among staff, custodial safekeeping, executing transactions (e.g., wire transfers of contributions to be invested and withdrawals of investment funds from custodial parties in order to pay benefits), and monitoring activity and operations.

- Investment Committee – Investment oversight committees should (could) be established to ensure sound investment practices. These committees do not generally make actual investment decisions, but rather act as overseers of the investment program.

Industry guidance provides that these principles (and the manner they are to be implemented) should be incorporated into a formal investment policy adopted by the government investor.

The value of investments in the City's defined benefit pension plan exceeds $900 million; those assets are invested through 15 external managers.

City Defined Benefit Plan. The value of investments in the City's defined benefit plan as of June 30, 2005, totaled $919 million. (Note: As of September 30, 2005, this amount had increased to $947 million as reflected in Table 2 that follows.) Because of the significant size of those investments and the expertise and resources necessary to ensure prudent and proper investments, the City exclusively uses "external managers" to invest assets for that plan. The individual external managers must invest within the parameters established in contracts executed with the City. As of June 30, 2005, there were 16 active contracts with 15 different managers involving 17 different investment accounts. In accordance with the diversification principle noted above, each manager is contractually required to invest in a specific category (style or type) of investment. Table 1 below shows the style breakdown as of June 30, 2005.

TABLE 1 – Defined Benefit Plan **Investment Portfolio Characteristics**			
Basic Investment Category (Style/type) **(Note 2)**	**Number of Active Investment Accounts**	**Value of Investments**	**Percent of Total Portfolio**
DOMESTIC EQUITY	8	$440,302,040	48%
FIXED INCOME	3	$298,939,463	33%
INTERNATIONAL EQUITY	2	$99,459,656	11%
REAL ESTATE	4	$69,225,597	7%
CASH AND CASH EQUIVALENTS	Not Applicable (Note 3)	$11,123,684	1%
TOTAL	**17**	**$919,050,440 (Note 1)**	**100%**

Note (1) Table data is as of June 30, 2005.

Note (2) The basic investments categories can be further broken down into sub-categories.

Note (3) Represents cash/cash equivalents temporarily invested in short-term funds by the custodial agent.

The City administers two separate defined contribution plans for City employees.

City Defined Contribution Plans. The City has two separate defined contribution plans for which the related investments were included in the scope of this audit. These include the following:

- Matched Annuity Pension (MAP) Program – While participation levels are different by employee class (i.e., general, police officers, and firefighters), this program is available to all permanent City employees. This program is administered by Prudential, a third party administrator. This program is designated a Section 401(k) Program by the Internal Revenue Service. As of September 30, 2005, the total value of investments in individual employees'/retirees' accounts was $216 million.

Eligible retiring general employees may elect to receive an additional benefit at the time they start drawing benefits under this program. That additional benefit is a one-time payment into their participant account equal to 50% of a designated balance within their account. To receive this benefit, retirees must agree to accept payment of their MAP account balances in the form of an annuity rather than a lump sum. These 50% benefit payments, or MAP distributions, can be substantial from a participant's perspective. For example, during the quarter ended September 30, 2005, MAP distributions totaling $567,891 were made on behalf of 14 retired employees. Instead of funding these MAP distributions on a pay-as-you-go basis, the City has established a separate investment account into which City funds are contributed. The amounts contributed are determined based on an actuarial study. As of September 30, 2005, the balance of City funds invested in that separate account totaled $59 million.

The value of City and employee assets invested through the two defined contribution plans approximates $289 million.

- Deferred Compensation Program – This defined contribution program is available to all permanent and temporary employees. This program is also administered by Prudential. This program is designated a Section 457 or Retirement Voluntary Saving Program (or RSVP) by the Internal Revenue Service. As of September 30, 2005, the total value of investments in individual employees'/retirees' accounts was $14 million.

(NOTE: In addition to the above defined contribution plans, there is a Supplemental Plan for Police Officers and a Supplemental Plan for Firefighters. However, the City does not contribute to or manage those funds. Accordingly, the related investments, totaling approximately $10 million, were not included in the scope of this audit.)

Summary of City Pension Investments. In summary, the City owns and/or has oversight responsibility for the following pension investments, which total $1,236,000,000 (in excess of one billion dollars): (NOTE: Of that total, $230,000,000 represents investments that are directed by employees/retirees within the array of funds offered through the City's defined contribution plans.)

TABLE 2 – SUMMARY OF CITY PENSION INVESTMENTS	
PLAN TYPE	**BALANCE (Note 1)**
Defined Benefit Plan	$947 million
MAP – Employee Accounts	$216 million
MAP – City investments used to fund 50% distributions	$59 million
Deferred Compensation	$14 million
TOTAL	**$1,236 million**
Note (1) – Balance as of September 30, 2005	

Overall Summary

The City has achieved its investment return goals and has a financially strong pension plan as a result; however, improvements are needed in regard to staff oversight and monitoring of pension investment activity, policies and procedures, documentation, and internal controls.

The results of our audit procedures showed that the City has achieved it investment return goals established for City pension plans. Where applicable, investment goals and returns, asset allocation strategies, and funding status compare favorably with similar local government pension plans within the state. For the defined benefit plan, the City has established an investment policy that, overall, establishes requirements and addresses applicable elements and components necessary to ensure a proper and prudent investment function. City pension investments were, generally, (1) in compliance with state laws, City ordinances, and City policies and (2) monitored and managed by Treasurer-Clerk staff. However, as addressed in some of the following sections of this report, areas for improvement were identified. Those areas include the need for:

- Improved monitoring and oversight of pension investment activities (earnings performance, contractual and policy compliance, fees, etc.);

- Enhancements to existing policies and procedures;
- Improved documentation of certain activities and decisions made in regard to City pension investments; and
- Improved controls over investment transactions.

To ensure compliance with applicable Florida Statutes that govern pension plans established for police officers and firefighters, changes are also needed in regard to the amount of pension assets invested in international securities.

Investment Performance – Defined Benefit Plan

The City has met its investment return goals for pension investments within the defined benefit plan. We performed various analyses and comparisons to measure the City's success in achieving its investment return goals. These individual analyses and results included the following.

We performed various comparisons and analyses that demonstrated that the City has met its investment return goals for the defined benefit pension plan.

Analysis No. 1 – We compared investment performance to that of 24 comparable investment plans pertaining to 14 other Florida municipalities. This peer group was identified after considering similarities in market value of plan assets, plan funding status, and actuarially assumed rates of return. Comparisons were made for the ten-year period 1995 through 2004. Information for this analysis was obtained from the State Division of Retirement, Bureau of Local Retirement Systems. For many of the 24 plans, data was available for only parts of the designated 10-year period. Accordingly, for each year, our comparisons only considered the plans for which data was available in that year. Comparisons were made considering the average rates of return (Table 3 below) and the City's performance ranking within that peer group (Table 4).

As shown in the following table, the City of Tallahassee (COT) consistently outperformed the annual average rates of return for the peer group.

TABLE 3 – Performance Comparison to Florida Municipality Peer Group "Average"				
Year	**COT Annual Investment Return (Note 1)**	**Average Annual Return of Other Plans in Peer Group (Note 2)**	**Number of Plans Included in Annual Comparison (Note 3)**	**Highest Performer (COT or the Peer Group)**
1995	29.69%	19.72%	13	COT
1996	16.72%	13.08%	15	COT
1997	24.3%	24.19%	15	COT
1998	16.43%	7.27%	16	COT
1999	14.04%	13.44%	17	COT
2000	.15%	10.16%	18	PEER GROUP
2001	(2.36%)	(5.87%)	20	COT
2002	(5.91%)	(7.05%)	17	COT
2003	20.74%	15.53%	12	COT
2004	11.53%	9.18%	6	COT
Average of annual returns	**12.53%**	**9.965%**		**COT**

Note 1: Calendar year basis as calculated by COT Investment Consultant; these returns were verified by audit on a sample basis.

Note 2: Likely a fiscal year basis other than calendar year.

Note 3: Data was not available on each plan for each of these years.

Note 4: Municipal entities that comprised the state peer group were Clearwater, Delray Beach, Ft. Lauderdale, Ft. Pierce, Gainesville, Hialeah, Jacksonville, Lakeland, Miami Springs, Orlando, Pensacola, St. Petersburg, Surfside, and Tampa. Some of these municipalities had multiple plans (e.g., separate plans for general, police, and firefighters).

Similarly, the following table shows that the City of Tallahassee (COT) generally (i.e., except for one year) performed better than most individual plans included in the peer group.

TABLE 4 – Performance Ranking Within Florida Municipality Peer Group			
Year	**Number of Plans Included in Peer Group (including COT)** **(Note 1)**	**COT Performance Ranking**	**Quartile in which COT Performed (i.e., first, second, third, or fourth)** **(Note 2)**
1995	14	1st	First
1996	16	1st	First
1997	16	6th	Second
1998	17	3rd	First
1999	18	8th	Second
2000	19	18th	Fourth
2001	21	6th	Second
2002	18	6th	Second
2003	13	1st	First
2004	7	1st	First

Note 1: Data was not available on each plan for each of these years.

Note 2: Quartile ranking refers to whether COT performance was in top 25% (first quartile), the second 25% (second quartile), the third 25% (third quartile), or the bottom 25% (fourth quartile).

Note 3: Municipal entities that comprised the state peer group were Clearwater, Delray Beach, Ft. Lauderdale, Ft. Pierce, Gainesville, Hialeah, Jacksonville, Lakeland, Miami Springs, Orlando, Pensacola, St. Petersburg, Surfside, and Tampa. Some of these municipalities had multiple plans (e.g., separate plans for general, police, and firefighters).

The City consistently outperformed the average and median investment performance of a peer group of similar local government pension plans within the state.

In summary, COT's average annual rate of return of 12.53% over the ten-year period 1995 through 2004 exceeded the average annual rate of return of 9.97% for the peer group (Table 3). In addition, COT performance was in the top quartile for five years, the second quartile for four years, and the bottom quartile for one year (calendar year 2000). For four of those ten years, COT performance was the highest of all plans for which data was available for those years (Table 4). Overall, this analysis reflects strong COT investment performance.

Analysis No. 2 – We reviewed comparisons, made by the City's investment consultant, of City investment performance to a peer group of 178 public fund sponsors (133 local government plans and 45 state and federal plans). Those comparisons also covered the ten-year period 1995 through 2004. The first comparison is on an annual basis (i.e., each year compared separately). The second comparison is on a cumulative basis (i.e., performance evaluated in total for specific multiple-year periods). A summary of those comparisons is reflected in the following tables.

TABLE 5 – "Annual" Performance Compared to National Public Fund Sponsor Peer Group (Note 1)

Year	Number of Plans Included in Peer Group	"Median" Rate of Return for Peer Group Note (2)	COT Rate of Return	Quartile in which COT Performed (i.e., first, second, third, or fourth) (Note 3)
1995	178	24.08%	29.69%	First
1996	178	13.48%	16.72%	First
1997	178	18.25%	24.30%	First
1998	178	14.78%	16.43%	Second
1999	178	12.52%	14.04%	Second
2000	178	1.09%	.15%	Third
2001	178	(2.74%)	(2.36%)	Second
2002	178	(8.28%)	(5.91%)	Second
2003	178	19.90%	20.74%	Second
2004	178	10.26%	11.53%	Second

Note 1: Comparison made and reported by the City's investment consultant on a calendar year basis.

Note 2: "Median" Rate of Return represents the middle value, for which one half of the plans performed above this value and the other half performed below this value.

Note 3: Quartile ranking refers to whether COT performance was in top 25% (first quartile), the second 25% (second quartile), the third 25% (third quartile), or the bottom 25% (fourth quartile).

For nine of the 10 years, COT performed better than the median rate of return for a peer group of 178 public pension plans identified by the City's investment consultant. For six of the last seven years, COT performed in the second quartile. For calendar year 2000, COT performed in the bottom quartile. For each of the first three years, COT performed in the first (top) quartile (Table 5).

TABLE 6 – "Cumulative" Performance Compared to National Public Fund Sponsor Peer Group (Note 1)

Cumulative Period Evaluated	Number of Plans Included in Peer Group	"Median" Cumulative Rate of Return for Peer Group Note (2)	COT "Cumulative" Rate of Return for Designated Period	Quartile in which COT Performed (i.e., first, second, third, or fourth) (Note 3)
1996-2005 (10 years)	178	8.10%	10.51%	First (99th percentile)
2000-2004 (5 years)	178	4.43%	4.33%	Third (46th percentile)
2002-2004 (3 years)	178	8.36%	9.57%	First (79th percentile)
2004 (1 year)	178	7.96%	10.04%	First (81st percentile)

Note 1: Comparison made and reported by the City's investment consultant. (Annual basis for this comparison was a July 1 through June 30 year.)

Note 2: "Median" Rate of Return represents the middle value, for which one half of the plans performed above this value and the other half performed below this value.

Note 3: Quartile ranking refers to whether COT performance was in top 25% (first quartile), the second 25% (second quartile), the third 25% (third quartile), or the bottom 25% (fourth quartile).

The City has demonstrated strong performance when compared to a peer group of public fund pension plans identified by the City's investment consultant.

On a cumulative basis for the ten-year period July 1, 1995, through June 30, 2005, the investment consultant's comparisons show that COT has outperformed 99 percent of the 178 public plans in the peer group. For the most recent five-year period, COT performance was slightly less (54th percentile) than the median performance of those 178 plans. But, for the most recent three and one-year periods, COT performance has rebounded into the top quartile (Table 6).

In summary, this peer group comparison suggests that COT has experienced strong investment performance over the most recent 10-year period in comparison to other public pension plans, with the strongest performance occurring during the earlier part of that period.

The City's investment performance has exceeded the policy benchmark

Analysis No. 3 – We compared investment performance to the earnings benchmark established in the City's investment policy for the defined benefit plan. Section 236.03 of the COT Pension Investment Policy established the following investment performance benchmark for the defined benefit plan.

> *"The aggregate portfolio is expected to earn a rate of return that exceeds the rate of inflation by at least 4% per year over rolling 10-year periods."*

For the most recent 10-year period that data was available to make this comparison (calendar years 1995 through 2004), we determined that COT performance has met this benchmark. Specifically, for that period, COT cumulative performance was an annualized rate of return of 11.96%, while the benchmark was calculated as an annualized rate of return of 6.45%. This is demonstrated in the following table (Table 7).

TABLE 7 – Performance Compared to Policy Benchmark

Policy Benchmark for 10-year period 1995 through 2004	**COT annualized performance for 10-year period 1995 through 2004**
6.45%	11.96%
COT investment performance has exceeded the policy benchmark for the most recent 10-year period data is available.	

The City's investment performance has exceeded the actuarially assumed rates of return.

Analysis No. 4 – We compared investment performance to the actuarially assumed rates of return used by the City's actuaries in the actuarial evaluations done for the plan. (NOTE: The actuarially assumed rate of return is the investment return that the actuary assumes the City will earn when determining the plan's funding status and recommending contribution rates. It is, in essence, a benchmark against which actual performance results should be compared.) As reflected in the following table, our comparison showed that COT cumulative performance for the 10–year period 1995 through 2004 (calendar year) was an annualized rate of return of 11.96%. This exceeds the annualized actuarially assumed rate of return of 7.90% for that period. Accordingly, COT investment performance has been more than sufficient to meet plan funding requirements based on actuarial assumptions (Table 8).

TABLE 8 – Performance Compared to Actuarially Assumed Rate of Return

Annualized Actuarially Assumed Rate of Return for 10-year period 1995 through 2004	**COT annualized performance for 10-year period 1995 through 2004**
7.90%	11.96%
COT investment performance has exceeded the annualized actuarially assumed rate of return for the most recent 10-year period.	

The City's successful investment performance has contributed to a financially sound defined benefit pension plan.

Analysis No. 5 – We reviewed the "funding status" of the plan. The funding status of a defined benefit plan is a measure of the degree to which the plan has accumulated assets (through contributions and related investment earnings) needed to pay present and future benefits. A plan with a higher funding status is in relatively better financial shape that a plan that has a lower funding status. A plan with a funding status of 100% means that, if a pension plan were to suddenly terminate on a given date and allow no more participation from that date forward, the existing assets in the plan would still be sufficient to pay all benefits that had been earned as of the termination date. On the contrary, a plan that is 75% funded means that, if a pension plan were to suddenly terminate on a given date under the same circumstances, the existing assets would only be sufficient to pay 75% of the benefits that had been earned as of that plan termination date

Actuarial valuations are required by state law to be completed at a minimum every three years. The last actuarial valuation done for the COT defined benefit plan shows that the plan is 110.8% funded. (Note: The last valuation was as of September 30, 2003; the next valuation will be as of September 30, 2005, which should be completed in the summer of 2006.) That funding status indicates that the City has been successful in accumulating assets sufficient to pay anticipated and earned benefits.

Overall, individual external investment managers selected by the City are performing well.

Analysis No. 6 – We reviewed investment performance history of the individual external managers as of June 30, 2005, as compared to benchmarks established by City investment policy, manager contracts, or industry standards. We also reviewed comparisons made by the City's investment consultant to peer groups identified by the consultant. A total of 22 different accounts (portfolios) involving 18 managers (some current and some not) were reviewed. Performance was evaluated over one, three, and five-year periods. Our analysis showed that overall, individual managers were performing well. In those few instances where managers have not met expected performances, Treasurer-Clerk staff has taken appropriate actions (e.g., terminating contracts and hiring new managers, or increasing on-going monitoring to determine if performance improves). As a result, cumulative performance by those individual managers has directly resulted in the solid investment performance demonstrated in Analyses No. 1 through 5 above.

Conclusion - Each of the six analyses and comparisons demonstrated that the City has been successful in meeting investment goals and in establishing a financially sound defined benefit plan.

Investment Performance – Defined Contribution Plans

Overall investment earnings performance for the City's Matched Annuity Program (MAP) and Deferred Compensation Program has been acceptable to strong. As described in the following, we made two analyses for these defined contribution plans. The first analysis was of the individual funds made available to City employees participating in those plans. The second was an evaluation of the performance of the City's special MAP account maintained at Prudential for the purpose of accumulating assets (through contributions and investment earnings) to make required MAP payouts to participating employees.

Our analyses showed that investment performance of the employee and City assets invested through the City defined contribution plans has been acceptable to strong, in all but one of the 10 funds currently available.

Analysis No. 1 - We reviewed the analysis made by the City's investment consultant to assess the performance of the ten funds made available to participants in the two City defined contribution plans. For that analysis, the consultant identified appropriate performance benchmarks for each of the ten funds, and measured performance against those benchmarks over the last quarter (i.e., quarter ended September 30, 2005), year, three-year period, and five-year period. The benchmarks included the median performance of peer groups of funds as identified by the consultant. Based on our review of that analysis, we determined:

- Investment performance for three funds has consistently exceeded each benchmark and the peer group median performance for each period analyzed.
- Investment performance for two funds has improved over the five-year period to the extent that current earnings are now better than the benchmarks and peer group median performance.
- Investment performance for two funds has been solid over the five-year period (i.e., exceeded benchmarks and peer group median), although recent earnings history has been slightly below the benchmarks and/or peer group median.
- For two funds, performance has been what was desired and expected (e.g., index fund).

- For the remaining <u>one</u> fund, performance has not met the consultant's benchmarks or peer group median over any of the reported periods during the last five years. In response to our inquiry on this matter, Treasurer-Clerk staff provided documentation showing that the fund's performance has been closely watched and that actions have been initiated to replace the fund with a better performer.

In summary, performance for the array of funds currently made available to City employees has been acceptable to strong, in all but one case. In that one instance where performance is not meeting expectations, actions have been initiated (February 15, 2006) to replace the applicable fund with a better performing fund.

Investment earnings on the City's MAP Program account for the last two fiscal years have exceeded the actuarially assumed rate of return for that account.

<u>Analysis No. 2</u> – As described in the Background Section of this report, the City maintains the special MAP account at Prudential from which to fund required MAP payments (payouts) to eligible retired employees. Because the individual benefits paid under this program are often substantial, the City has taken a proactive approach by setting aside and investing funds in order to accumulate a "pool" of funds to pay the City's portion for employees selecting the matched annuity option. From a budgeting and fiscal perspective, this pre-funding approach is preferred compared to paying benefits from current budgetary funds (e.g., from the City general fund) as they come due (i.e., pay-as-you-go approach).

The City hired an actuary to determine the amount of City funds that should be contributed into and invested through this MAP account. This was done to ensure that sufficient funds were available on an ongoing basis to fund the required payouts. In making that calculation of the amounts that should be contributed and invested each period (i.e., pay period), the actuary assumed that the rate of return on the invested funds would be 7.75%. Accordingly, we compared the actual annualized rate of return on those funds for the last two complete fiscal years since the actuarial valuation (October 1, 2003, through September 30, 2005) to that actuarially assumed rate of return. The results, presented in the following table, show that the City's rate of return has exceeded the actuarially assumed rate of return (Table 10).

TABLE 10 – Performance of City MAP Account Compared to Actuarially Assumed Rate of Return	
Actuarially Assumed Rate of Return for two-year period (Fiscal Years 2004 and 2005)	**COT annualized performance for two-year period (Fiscal Years 2004 and 2005)**
7.75%	10.3%
COT investment performance has exceeded the actuarially assumed annual rate of return for the most recent two-year period.	

Accordingly, based on this internal benchmark, the earnings on that special MAP account exceeded expectations over the most recent two fiscal years.

Conclusion – Overall, the City has been successful in selecting funds that meet earning requirements and expectations for the two defined contribution plans.

Compliance with Governing Laws and Legal Requirements

In addition to City ordinances, the City's pension investments are subject to the provisions of several state laws. Those laws include:

The City's pension investments are subject to provisions of certain state statutes.

- Chapter 112, Part VII, Florida Statutes, which addresses and/or requires:
  - A system of internal controls and operational procedures.
  - A written investment policy;
  - Diversification of assets (investments);
  - Performance measures to evaluate earnings experience;

   - Authorized investments, including investment limitations;
   - Maturity and liquidity requirements; and

- Section 215.47, Florida Statutes, which addresses authorized investments, including investment limitations.
- Chapters 175 and 185, Florida Statutes, which address authorized investments and investment limitations for police and firefighter pension plans.

We reviewed activity, records, and processes relative to pension investments for compliance with the applicable state statutes. Overall, we found that the City was in compliance with the various legal provisions and requirements. However, as addressed below, we identified an issue where the City needs to make appropriate changes to ensure compliance. (NOTE: One other issue that pertains to investment policy statements required by state statute is addressed in the following report section on "Investment Policy.")

The value of City pension investments in international securities exceeds the maximum amounts allowed by state statute for police and firefighter pension plans.

For the police and firefighters defined benefit pension plans, the amount of investments in international equities exceeded the maximum allowed by state law. Chapters 175 and 185, Florida Statutes, provide that pension plan assets (police and firefighter) invested in foreign (international) securities cannot exceed 10% of total plan assets. The purpose of this provision is to limit the exposure of plan assets to risk.

In the City, police and firefighter plan contributions are commingled with general employee contributions for investment purposes. Accordingly, each of these three distinct pension plans owns a pro rata share of the total investments.

Contrary to the legal maximum stated above for police and firefighter plans, the City pension policy provides that up to 15% of defined benefit plan investments can be invested in international equities. (Note: While the target amount is 10%, the policy allows as much as 15%.) In addition, the policy allows for another unspecified portion of the total investment portfolio to be invested in international fixed income securities.

Our analysis showed that more than 10% of City defined benefit plan investments have consistently been invested in international securities. As of June 30, 2005, a total of 14.2% of the market value of defined pension plan assets were invested in international securities. Also, for each of the quarters ended March 31, 2005, December 31, 2004, September 30, 2004, and June 30, 2004, plan assets invested in international securities exceeded 10% of the plan's total portfolio market value by similar margins.

We recommend that the Treasurer-Clerk modify the City investment policy for the defined benefit plan to provide for compliance with Chapters 175 and 185, Florida Statutes. Current investments that exceed the noted 10% limitation should be reinvested in other allowable securities.

Investment Policy

City Commission Policy #236 is the City's investment policy for the defined benefit plan. That policy addresses essential aspects of the investment function for that plan's assets, including:

- Fiduciary standards.
- Goals and purpose.
- Asset allocation strategies and maintenance.
- Cash reserves.
- Operating policies.
- Guidelines and evaluation criteria for external managers.

City Commission Policy #236 is the City's investment policy for the defined benefit pension plan.

- Investment objectives measurement standards (benchmarks) for managers by category/style.

As part of our audit, we evaluated the adequacy of this policy as well as compliance with policy provisions. We also inquired into the existence of a similar policy for the defined contribution plans.

Overall, we found the investment policy for the defined benefit plan adequate and plan investment activities were in compliance with that policy. However, several issues were identified as noted in the following.

The City should establish a separate investment policy for the defined contribution pension plans.

The City has not established a separate investment policy for the defined contribution plans. City ordinances 14-6.004 and 14-6.504 provide that moneys of the City's Deferred Compensation Program shall be invested as provided by an investment policy adopted by the City's sinking fund commission. While there is no similar ordinance requiring that moneys of the City's MAP Program be invested as provided by a formally adopted investment policy, industry guidance and practices suggest that formal investment policies be established for all defined contribution plans (i.e., as well as for defined benefit plans). Contrary to the referenced ordinance and industry guidance, we noted that the City has not established a formal investment policy for the two defined contribution plans.

Adopting a formal investment policy for the MAP and Deferred Compensation Programs would demonstrate the City's due diligence in regard to establishing and operating those plans, provide a means of communicating investments goals and priorities to any applicable party (e.g., plan participants, third party administrators, Treasurer-Clerk staff, money mangers), and strengthen internal controls by establishing roles and requirements.

Accordingly, we recommend that the Treasurer-Clerk's Office provide for the establishment of a formal investment policy for the defined contribution plans. Some areas that should be considered for inclusion in that policy are:

- Statement of purpose – rationale for the plans and investment goals.
- Roles and responsibilities of key decision makers (e.g., Investment Advisory Committee, Treasurer-Clerk staff, third party administrator, consultant).
- Standard of care – decision makers should be expected to make prudent investment decisions.
- Investment strategies – the type of investment instruments and categories (e.g., equities, fixed-income, international, real estate) to make available to plan participants.
- Performance expectations - benchmarks against which performance will be measured.
- Reporting and monitoring – what reports should be generated and what monitoring of performance and compliance will be performed.

City Commission Policy #236 for the defined benefit plan should be revised to address internal controls and require documented operational procedures.

The City investment policy for the defined benefit plan should be revised to provide for a system of internal controls and operational procedures. One of the many legal provisions applicable to the City is the requirement in Chapter 112, Part VII, Florida Statutes, that the investment policy provide for a system of internal controls and operational procedures. While there is a citywide policy adopted by the City Commission on internal controls, that policy is not specific to the investment function. The City's investment policy does not contain a statement or language on internal controls. We also noted that the investment policy does not require or provide for documented operational procedures.

For the most part, our review showed that adequate internal controls and procedural processes were in place in regard to pension investments. However, as addressed in the subsequent sections of this report, internal control and procedural issues were identified. To comply with Chapter 112, Part VII, and to help ensure an appropriate pension investment function, we recommend that the investment policy be revised to specifically require and provide for (1) an adequate system of internal controls and (2) documented operational procedures for the pension investment function.

Specific areas that should be considered and addressed as part of those documented operational procedures include, but are not limited to, the following:

- Transfers and withdrawals of funds to and from custodians and any other entities.
- Receiving, reviewing, and approving fees/invoices for managers, custodians, and consultants.
- Ensuring compliance with applicable contractual terms and provisions for external managers, custodians, and consultants.
- Reviewing overall plan and individual manager performance, including applying benchmarks in those reviews and taking actions for poor performance.
- Ensuring asset allocation compliance and adjusting the portfolio to maintain that compliance.
- Selecting new external managers.
- Providing/issuing instructions to external managers and the custodian.
- Filing applicable documents pertaining to external managers, custodians, consultants and other parties (e.g., for security lending), including, but not limited to:
    - Contracts.
    - Invoices.
    - Periodic activity statements and reports.
    - Other correspondence.

- Scheduling, holding, and documenting periodic IAC meetings, including preparation and obtaining approval of meeting minutes.
- Specific internal controls that should be in place (e.g., segregation of duties, reconciliations of custodian records to external manager records, etc.).

(NOTE: In the following sections of this audit report, issues are identified and specific recommendations are made for improving internal controls and documenting processes and procedures.)

An exhibit to City Commission Policy #236 should be modified to clarify that real estate investments are not limited to a single named external manager.

An exhibit in the defined benefit plan policy should be modified to clarify that investments in real estate are not limited to a single external manager. Exhibit A to the City's investment policy for the defined benefit plan implies that a specific entity (JP Morgan) will be the sole external manager for plan assets invested in real estate (i.e., real estate trusts or real estate securities). No other external managers are addressed in the policy (including exhibits). However, the plan's real estate portfolio is invested through two separate external managers. In response to our inquiry on this matter, Treasurer-Clerk staff indicated that it was not intended to limit real estate investments to the one manager noted in the policy. They further indicated that the policy exhibit should be revised accordingly. We recommend that the Treasurer-Clerk initiate modification to the policy to clarify that real estate investments are not limited to a single external manager.

Evaluating and Monitoring Investment Performance

Objectives for this audit included evaluating the Treasurer-Clerk's process for reviewing and monitoring investment performance. Performance should be monitored at the overall plan level to determine if goals and objectives for the overall plan are achieved. Performance should also be monitored for the individual external managers (defined benefit plan) and fund managers (defined contribution plan) to determine if goals and objectives for those managers/funds are achieved. Monitoring activities provide management information needed to make appropriate adjustments in investment activities.

Overall, monitoring of investment performance is adequate; however, improvements are needed.

We noted that the Treasurer-Clerk's investment staff does monitor performance. This monitoring is done primarily through detailed periodic reports prepared and presented by the City's contracted investment consultant. These reports provide detailed information on overall plan and individual manager performance. Performance is tracked and reported for the most recent quarter through the most recent 10-year period.

Overall, the monitoring process of investment performance is adequate. However, the following issues were noted.

Contrary to investment policy requirements and good practices, external manager investment performance is not measured and reported net of fees.

Contrary to policy requirements, the investment consultant measures, reports, and presents external manager performance "gross" of manager fees. To make a complete and objective evaluation of an individual external manager's performance, both investment earnings and fees paid for the manager's services must be considered. For example, if a manager earned $20,000 in a quarter and the City paid fees of $10,000 for the manager's services, net earnings to the City would only be $10,000. In accordance with this concept, the City's investment policy for the defined benefit plan provides that investment performance for individual funds (managers) will be measured after fees on a total return basis.

Contrary to this concept, investment performance as reported and presented by the City's investment consultant for the defined benefit plan was gross of fees (i.e., fees were not deducted). No other evaluation was conducted by Treasurer-Clerk staff to determine and review performance net of fees. While the Treasurer-Clerk staff are generally aware of the fee structures charged by each of the multiple external managers, the lack of a formal comparison of performance after fees (or net of fees) makes accurate and effective performance monitoring a difficult task, at best.

We recommend that the Treasurer-Clerk's Office measure and evaluate individual manager performance net of fees.

Contracts with many external managers do not address or reference policy performance benchmarks.

<u>Some contracts with external managers did not address policy benchmarks</u>. We reviewed 22 contracts executed with external managers during the period 1994 through 2004. We noted that 10 of those contracts did not include or address benchmarks. In response to our inquiry on this matter, Treasurer-Clerk staff stated that a copy of the investment policy (which contains benchmarks) was provided to each manager prior to or at the time of contract execution. In addition, the Treasurer-Clerk's staff indicated that any manager could be terminated for poor performance as determined by the City at any time, regardless of whether the manager was aware of the benchmarks.

Notwithstanding these explanations and reasoning, establishing and formally communicating benchmarks should help ensure that managers hired to invest pension assets are aware of performance expectations against which they will be measured. Such information may serve as an incentive for those managers. We recommend that future contracts executed with external managers contain the appropriate policy benchmark. Alternatively, those contracts should contain a direct reference to those policy benchmarks against which performance will be measured.

The Treasurer-Clerk's Office should establish written procedures documenting the process for evaluating performance of pension investments.

<u>Procedures and methods for evaluating performance of both the defined benefit plan and defined contribution plans should be documented (i.e., in addition to a formal "policy")</u>. As noted above in the report section on "Investment Policy," state statute requires that the investment policy provide for a system of internal controls and operational procedures. We noted that the Treasurer-Clerk's staff does have an effective process for monitoring and evaluating investment performance. We recommend that process be documented in formal procedures. Those procedures should address, at a minimum:

- The timing and frequency of performance analyses and comparisons.
- The roles of each party (i.e., Treasurer-Clerk staff, investment consultant, and Investment Advisory Committee).

- The benchmarks against which performance will be measured.
- Appropriate actions to take based on performance results (e.g., replacing poor performers with another manager/fund).
- The documentation prepared and retained to document the monitoring and evaluation process and any resulting decisions and actions (e.g., investment reports, minutes from Investment Advisory Committee meetings, decisions made).

Formalizing and documenting current procedures and methods should help ensure consistency in the performance evaluation process.

Selection of External Managers and Funds

Industry guidance and sound business practices provide that selection of external managers (defined benefit plan) and investment funds (defined contribution plan) should be based on a competitive, merit-based process. Criteria and factors that should be used and considered in the selections include the following:

The Treasurer-Clerk uses a competitive and merit-based approach in the selection of external managers and funds.

- The category/style of investments made by the manager/fund.
- The decision making process used by the manager/fund.
- Stability of key personnel employed by the manager or fund.
- Number of years the manager/fund has been in business/existed.
- Size (dollar amount) of other public pension fund assets under current management.
- Size (dollar amount) of total assets in the specific category/style being considered.
- Investment performance (earnings track record).
- Education and experience of key personnel that will be managing the applicable investments.
- Fees for services.

One acceptable approach based on industry practices is to use an investment consultant to assist in the selection process. The City employs that approach. The process used by the Treasurer-Clerk's Office in selecting a manger or fund involves:

- Treasurer-Clerk staff notifies the contracted investment consultant (Segal) of the category/style investment desired (e.g., small, mid, or large cap domestic equity; corporate bonds; government fixed-income instruments; international equity; real estate).
- The consultant then researches and identifies a listing of potential managers or funds for the City to evaluate. The consultant often makes a presentation to Treasurer-Clerk staff and provides various data and information (i.e., see preceding criteria).
- After the presentations by the consultant and review of the related materials, Treasurer-Clerk staff selects the best potential managers/funds (usually three or four are selected) to interview, and has those entities make individual presentations to Treasurer-Clerk management.
- Treasurer-Clerk management selects the best candidate and executes an investment contract.

This process is competitive and merit-based. In addition, having the investment consultant identify the initial pool of potential managers/funds helps eliminate any actual or perceived conflicts of interest by Treasurer-Clerk staff in the selection process.

Better documentation is needed to explain and justify the Treasurer-Clerk's manager and fund selection decisions.

Better documentation should be prepared and retained explaining and justifying the Treasurer-Clerk's manager/fund selection decisions for both the defined benefit and defined contribution plans. The Treasurer-Clerk's Office appears to have an adequate and appropriate process established to select and hire new external managers and funds. However, there is no formal documentation or records that explain/justify the decisions made in (1) selecting which managers or funds to interview from the initial pool identified by the consultant or (2) selecting the manager/fund to hire.

In our review of two recent external manager selections for the defined benefit plan, we noted a few marginal, handwritten notes showing where Treasurer-Clerk staff evaluated and considered criteria and factors for potential managers and funds. Documentation explaining and justifying the final decisions were not, however, included in those selection records. Furthermore, in our review of two recent fund selections for the defined contribution plans, we noted that documentation was not available to show the potential funds considered and to show that comparisons had been made among potential funds as to earnings history, size and age of funds, manager experience and reputation, and fees. Records were not otherwise available to explain and justify the two fund selections that were made.

Without documentation that clearly substantiates the selection criteria applied and evaluated and decisions made, the Treasurer-Clerk's Office reduces the ability to justify those selections. (See the following issue.) We recommend that the Treasurer-Clerk's Office document:

- The specific funds evaluated and considered for the defined contribution plans.
- The criteria applied and evaluated in the selection of funds for the defined contribution plans.
- The decision process and justification for (1) potential managers (defined benefit plan) and funds (defined contribution plans) selected to be interviewed from the initial pools identified by the consultant and (2) the manager/fund subsequently hired.

Procedures and methods for the selection and hiring of external managers and investment funds should be documented as part of the Office's operational procedures.

The Treasurer-Clerk's Office should establish documented procedures for the selection and hiring of external managers and investment funds. As noted above, the Treasurer-Clerk's Office appears to have an adequate and appropriate manager and fund selection process. However, that process is not formally documented in written procedures. To help ensure consistency and compliance with that process, we recommend that the Treasurer-Clerk's Office establish written procedures that address the criteria considered and methods used. (See the lead-in paragraphs in this section of the audit report for an overview of the criteria and process.)

Contract Compliance - Custodial Agent

As part of our audit we reviewed compliance with various terms and provisions in the custodian (State Street) contract. Overall, we found that the contract was administered in compliance with governing terms and conditions. However, several issues were identified that indicate the Treasurer-Clerk staff should enhance their review of the custodian's quarterly fee invoices.

Enhancements are needed to the review process to ensure that custodian fees are properly and correctly invoiced and paid.

Treasurer-Clerk staff should enhance their review of custodian invoices to ensure that fees invoiced and paid are appropriate. Our review disclosed errors in the fees invoiced by and paid to the City's custodial agent (State Street). In addition, we noted that sufficient data was not obtained and reviewed by Treasurer-Clerk staff to validate the "trade fees" charged by State Street. The applicable issues are addressed below.

Issue No. 1 We found that State Street incorrectly included global (international) account values in the base against which the domestic fee was determined (i.e., there are separate fee components for the domestic and global values). As a result, we estimate the City overpaid State Street approximately $24,750 over the most recent 11 quarters.

We identified custodian errors that resulted in the City being over-billed approximately $24,750 over the most recent 33 months.

This issue was addressed with State Street who confirmed the estimated overcharges. However, in response to their review of the overcharges, State Street asserted that they also identified significant account undercharges. State Street asserted that after considering both the overcharges and undercharges, the City had been undercharged by a net of $32,799. State Street indicated that it was willing to forego requesting the City to pay the $32,799 and that it had instituted additional review procedures to ensure that subsequent fees were correctly and accurately billed.

Subsequently, the custodian identified other errors that resulted in under-billings which more than offset the identified over-billings.

We were able to confirm that the City had in fact been undercharged for the reasons indicated by State Street (i.e. State Street inadvertently excluded from the fee calculations (1) certain account values for one quarter, (2) international values of one account for several quarters, and (3) various associated trade fees).

At the close of this audit, Treasurer-Clerk staff was in the process of confirming that the City had in fact been undercharged by the amounts asserted by State Street.

Notwithstanding that the net overcharges and undercharges are not significant when considering the value of the defined benefit pension portfolio (more than $1 billion), it is demonstrative of the need for enhanced review of State Street invoiced fees by Treasurer-Clerk staff. Accordingly, we recommend that the Treasurer-Clerk staff enhance their review of State Street invoices and ensure that amounts invoiced are in accordance with contractual terms and provisions.

We determined that certain non-pension investment fees were incorrectly billed and paid on the custodian invoice for pension investments

Issue No. 2 State Street serves as the City's custodian for both pension and non-pension investments. The custodian fee for non-pension investments is billed separately and is based on a separate contract and fee schedule. The contractual fee schedules for both the pension and non-pension investments provide for a "portfolio fee" as one of the fee components. We noted that the portfolio fees for both the pension and non-pension investments were incorrectly combined by State Street and billed on the invoice for the pension investments. On an annual basis, we estimate that this has resulted in the pension fund incorrectly paying fees of $18,000 that should instead have been paid from non-pension funds. Treasurer-Clerk staff that reviewed and approved these invoices did not detect this error. In response to our inquiry on this matter, State Street acknowledged the error and stated that subsequent invoices would be correctly billed.

As also recommended for Issue No. 1 above, Treasurer-Clerk staff should enhance their review of State Street invoices to ensure that amounts invoiced are in accordance with contractual terms and provisions.

Treasurer-Clerk staff should develop a cost-effective means to verify the reasonableness of trade charges included on the custodian's quarterly invoices.

Issue No. 3 On an annual basis the City pays State Street approximately $180,000 for approximately 8,500 to 9,000 trade transactions. While we were able to verify that the fees charged per transaction were correct, sufficient data and information was not obtained by Treasurer-Clerk staff to ensure the number of trade transactions (by type and in total) was reasonably correct. We realize that it may be cost prohibitive for Treasurer-Clerk's staff to verify the validity of each individual trade transaction charged by State Street. However, it would be practicable for Treasurer-Clerk staff to analytically determine what a reasonable range of trade transactions (i.e., develop a "baseline") and then compare the number of trades charged each quarter to that baseline. Any significant differences should then be investigated to ensure amounts charged are proper. We recommend that Treasurer-Clerk staff request that State Street make available the detail of individual trade transactions for which the City is invoiced. Treasurer-Clerk staff should use that information to (1) develop a baseline against which future invoiced trades can be compared and (2) investigate and verify the validity of any unexpected fluctuations from that baseline.

Written procedures providing for the review of custodian quarterly invoices should be developed and implemented.

The Treasurer-Clerk's Office should establish written procedures for the review of custodian invoices. As evidenced by the previous comments, Treasurer-Clerk staff has not adequately reviewed State Street invoices to ensure fees billed and paid are correct. Written procedures have not been established requiring appropriate and adequate reviews of those invoices. We recommend such procedures be developed and implemented.

External Managers – Policy and Contractual Compliance and Administration

The Treasurer-Clerk's Office executes separate contracts with each external manager. Each of the 16 contracts (involving 15 managers and 17 investment portfolios) that were active as of June 30, 2005, was reviewed for the following:

- Compliance with applicable investment policy requirements and provisions.

- Compliance with applicable contractual terms and conditions.
- Compliance with established fee schedules.
- Appropriateness of certain contractual language.

As of June 2005, the City had 16 contracts with 15 external managers for17 investment portfolios.

Our review showed that, for the most part, managers were in compliance with policy and contractual requirements and provisions, fees were correctly invoiced and paid, and contract language was adequate and consistent with the investment policy provisions. However, as noted in the following, several issues were identified that are indicative of the need for enhanced monitoring and oversight by Treasurer-Clerk staff.

We found one instance where a manager invested $7.2 million of pension assets in unallowable securities.

In one instance a fixed income manager maintained a portion of the City's investment portfolio in unallowable securities. The defined benefit investment policy precludes investment of City pension funds in certain designated securities and assets. Those unallowable securities include "inverse floaters" and "interest-only mortgage-backed securities" (investments that typically carry more risk of principal loss compared to generic stocks and bonds). Contrary to policy, we noted that one fixed income manager invested $4.6 million of City assets in inverse floaters and $2.6 million in interest-only mortgage backed securities. Those investments represented 6.67% of that individual portfolio (but less than 1% of the total plan investments).

We recommend that Treasurer-Clerk staff enhance their review of activity to ensure only allowable investments are made by external managers. We also recommend that Treasurer-Clerk staff direct the manager to reinvest those assets in allowable securities. Alternatively, if the Treasurer-Clerk determines those investment instruments to be acceptable, appropriate adjustments should be made to the investment policy. (In response to our audit inquiry, Treasurer-Clerk staff indicated that the policy likely would be modified to allow a limited amount of these relatively risky investments due to the favorable returns that can be generated.)

Two instances were noted where contractual limitations on or requirements for investments were not met by external

<u>managers</u>. Of numerous contractual investment requirements pertaining to authorized investments, required diversifications and allocations, and investment quality, two instances were noted where specific requirements were violated. Specifically:

Two instances were identified where external managers did not meet contractual limitations on or requirements for investments.

- One equity manager maintained 38 different securities in the City's investment portfolio when the contract provided for the holding of 25 to 35 securities.
- One international equity manager invested 32% of the City's portfolio in a single industry (financial industry) when the contract provided for a maximum of 25% in any single industry.

Neither violation represents a significant risk to the overall defined benefit plan investment portfolio. However, this is indicative of the need for Treasurer-Clerk staff to monitor for compliance with specified contractual terms and conditions, and to ensure appropriate corrective action is taken for any identified issues. We recommend that Treasurer-Clerk staff monitor external manager activity for contractual compliance.

<u>Written procedures should be established to address the current process of paying manager fees based on manager-reported values instead of custodian-reported values</u>. The defined benefit plan investment policy provides that manager fees are to be based on asset values as determined by the custodian (State Street). In our review of the fees paid for the 16 contracts, we noted that fees for 10 contracts were assessed and paid on values as reported by the managers when those values were slightly different from values reported by the custodian. In some instances this resulted in the City paying less quarterly fees (e.g., for seven managers the City paid amounts ranging from $2 to $432 less than what would have been paid based on custodian-reported values). In three instances this resulted in the City paying higher quarterly fees in amounts ranging from $3 to $233.

The process of paying fees based on manager-reported values instead of custodian-reported values when the differences are not significant should be formalized in written operational procedures.

In response to our inquiry on this matter, Treasurer-Clerk staff responded that if the fees based on the manager-reported values are not "significantly" different from the fees based on the custodian-reported values, the fees are paid as invoiced by the manager. While this practice is reasonable, there are no written procedures allowing for this approach and no formal dollar threshold for accepting or rejecting the fees when there are differences. If the Treasurer-Clerk's Office elects to continue this process, we recommend that the process be documented in formal written procedures approved by Treasurer-Clerk management. As part of those procedures, we recommend that a formal dollar threshold be established to delineate when fees should be (1) paid as invoiced or (2) rejected and instead paid based on custodian-reported values.

Enhancements should be made to address or directly reference key investment policy provisions and requirements in contracts with external managers.

Contracts with external managers did not always address compliance with certain key policy provisions. Specifically, manager contracts did not (1) limit single holdings to no more than 10% of the portfolio managed for the City; (2) limit the total market value of the 10 largest equity holdings to no more than 60% of the portfolio managed for the City; (3) limit cash balances for equity managers to no more than 5% of the portfolio managed for the City (in one instance a contract did limit the amount of cash balances but the limitation was 10% and not the 5% provided by the policy); and (4) preclude fixed income managers from investing in certain prohibited securities such as inverse floaters. Treasurer-Clerk staff indicated that all managers were provided copies of the City's investment policy prior to or at the time of contract execution. In addition, we determined that, except for the instances noted above, managers were in compliance with these policy provisions. Notwithstanding those circumstances, we recommend that these key policy provisions be incorporated into contracts (either by direct inclusion, by direct reference, or as an appendix/exhibit) to avoid inappropriate investment risk and risk of non-compliance.

Treasurer-Clerk staff did not always maintain contractual documents and other records necessary to properly review and approve manager fees and review manager performance and compliance with applicable terms and provisions. In the following instances, Treasurer-Clerk staff did not maintain copies of contract documents and fee schedules needed to ensure invoiced fees were correct and proper.

Efforts should be improved to ensure that key contractual documents and other records are obtained and properly filed and retained.

- For two accounts with one external equity manager (contract executed in December 2004), Treasurer-Clerk staff could not provide the contractual fee schedule upon our initial request. Treasurer-Clerk staff was subsequently able to obtain a copy of the fee schedule directly from the manager on December 15, 2005. Without that fee schedule, it was not apparent how Treasurer-Clerk staff was able to adequately ensure that invoiced fees paid in June and November 2005 were correct and proper.
- For one account with a real estate manager, the fees were not invoiced to and paid by the City. Rather, the real estate manager withheld the fee amounts from cash distributions (i.e., income earned on investments) submitted to the City. Although we were able to subsequently verify that the correct fees were properly withheld, evidence indicated that Treasurer-Clerk staff had not made such reviews and verifications. Specifically:
    - Similar to the previous finding, Treasurer-Clerk staff could not provide a copy of the applicable fee schedule but had to obtain it directly (in January 2006) from the manager upon our audit request.
    - There was no evidence on the distribution statement received from the manager that showed Treasurer-Clerk staff review and approval.
    - In response to our original inquiry, Treasurer-Clerk staff initially responded that fees had not been applied to date, as it was a relatively new account (i.e., contract executed in December 2004).

In one instance we determined that a real estate manager was incorrectly sending investment income distributions directly to the City's bank account instead of the pension plan custodian.

In addition to the above, we noted that Treasurer-Clerk staff was not aware that fees (totaling $81,790 as of September 30, 2005) and cash distributions (totaling $218,351 as of September 30, 2005) for that real estate manager were not reflected on the custodian's account statements. Based on audit inquiry and research, we determined that occurred because the manager had been incorrectly wire transferring the cash distributions net of fees ($136,561) into the City's operating bank account when those funds should have been transferred to the custodian (State Street) for safekeeping. Treasurer-Clerk staff was not aware of these events, as manager activity was not being adequately and timely monitored.

In addition to funds not going to the proper entity and account and the lack of verification of fees withheld, this resulted in the fees and distributions not being properly recorded and accounted for in the City's accounting system. (NOTE: While the bank reconciliation performed by Accounting Services should have detected that the funds were being incorrectly transferred into the operating bank account, we determined that the reconciliation process in Accounting Services was not properly and correctly performed. As a result, that process also did not detect the incorrect receipt and accounting for pension income and fees from this real estate manager. This is addressed as a separate issue in a subsequent section of this report.)

We recommend that actions be taken to ensure that adequate and timely reviews are made of fees paid and distributions received. Those actions should include obtaining and retaining fee schedules necessary to conduct those reviews.

Appropriate procedures and processes should be developed and implemented to monitor external managers for compliance with key policy requirements and contractual provisions.

A formal process should be developed and implemented to ensure that external managers are in compliance with policy and contractual provisions. Based on the previous issues addressed within this report section and discussions with Treasurer-Clerk management, it is apparent that adequate procedures have not been implemented to ensure that managers comply with policy and contractual provisions, such as asset allocation/diversification, maximum holdings, allowable and unallowable investment securities, fees, account distributions, etc. To help preclude instances as described above, we recommend that the Treasurer-Clerk staff develop a process whereby activity for each manager is periodically reviewed for compliance with applicable policy requirements and contractual terms and provisions. Consideration should be given to development of a standard checklist for this purpose.

Security Lending Program – Contractual Compliance and Administration

One aspect of the City's pension investment program is the security lending function. Security lending involves the temporary loaning of securities (e.g., stocks and bonds) to other entities in return for a fee. To protect the entity loaning the securities (e.g., the City), the borrower is required to put up sufficient collateral (often cash). The fee earned by the loaning entity is negotiated and consists of, for example, earnings on invested cash collateral.

The City uses a security - lending program to increase earnings on pension investments.

Because of the complexities involved, public pension plans generally contract with a separate entity to administer their security lending function. Fees are negotiated with the administering entity, and often consist of a negotiated split of earning on the loaned securities. During our audit period, the Treasurer-Clerk's contract was with State Street Bank and Trust, the same entity that serves as the City's custodial agent. That contract provided for the earnings to be split 65% to the City and 35% to State Street. (NOTE: Subsequent to our audit period, the Treasurer-Clerk's Office commenced negotiating a new contract with a different entity for its security lending function.)

After obtaining access to applicable information, we found that the securities lending function was properly administered. Specifically:

- Reported earnings appeared reasonable based on industry practices and reported loaned securities.
- As reported, collateral was obtained as required (both in type and amount).
- Reported gross earnings were properly allocated between the City and State Street.

- Reported earnings were properly recorded in the City's accounting system.

Also, State Street made available monthly reports to Treasurer-Clerk staff on the results of securities lending activity.

Monitoring of security lending activity should be enhanced to ensure that shared earnings are correctly allocated to the City, collateral is of the proper type, and loan earnings by category are reasonable.

We determined that Treasurer-Clerk's monitoring of securities lending activity should be enhanced. While Treasurer-Clerk staff did determine and review reported net program earnings paid to the City, they did not obtain access (via secured website) to available monthly activity (detailed and summary) on the lending program until after our audit inquiry. Without those reports, Treasurer-Clerk staff was not able to ensure that: (1) loan earnings were properly allocated between State Street and the City, (2) collateral obtained was the proper type (e.g., cash or government securities), or (3) loan earnings by security category was reasonable. Furthermore, the loan information available prior to Treasurer-Clerk staff obtaining access to State Street's monthly reports was not organized and presented in a manner to allow efficient oversight of securities lending activity.

In response to our inquiries and discussions on the matter, Treasurer-Clerk staff obtained access to State Street's secured website needed to access the monthly activity reports. In addition to that corrective measure, we recommend that Treasurer-Clerk management establish a formal, documented process (i.e., written procedures) for periodically reviewing appropriate security lending activity reports to ensure that function is properly and efficiently administered.

Internal Controls

Overall, internal controls were adequate in regard to the initiation and execution of pension investment transactions.

In connection with our stated audit objectives, we reviewed and evaluated the system of internal controls relative to the pension investment function. The results of our evaluations are reflected in various comments throughout previous sections of this report (e.g., need for improved documentation and procedures). This report section addresses other areas, including controls over the initiation and execution of investment transactions (e.g., transferring contributions for investment and withdrawing invested assets to fund the retirement payroll). This report section was also used to report any other unique areas (e.g., review and approval of Investment Advisory Committee meeting minutes).

Overall, we found that adequate controls were in place in regard to the initiation and execution of investment transactions. Duties were generally segregated such that no one employee controlled all components of a transaction. Approvals of transactions by the appropriate authority were required and performed. Access to assets was adequately restricted and controlled. However, as noted in the following, we did note some areas where improvements in the control structure are appropriate.

Incompatible system permissions within the bank's wire transfer system should be assigned to different employees.

The Treasury Analyst position has been assigned incompatible system permissions for the bank's wire transfer system. The Treasurer-Clerk uses the wire transfer system of the City's commercial bank to wire transfer contributions to the custodian (State Street) for investment. Essential controls for executing those wire transfers are built into that system. For example, the system requires at least two different system permissions to execute a wire transfer; one to initiate or create the transaction and another to approve the transaction. Additionally, except as noted below, the system permissions have been assigned to different staff in the Treasurer-Clerk's Office so that no one individual employee can both initiate/create and approve the same transaction.

The ability to establish individual system permissions is made by the designated "system administrators." In accordance with proper internal control practices, the bank's wire transfer system requires two different system administrator permissions to set system permissions for the different Treasurer-Clerk staff. One system administrator permission is required to "initiate" the establishment of a new system permission for an employee, while the other system administrator permission must then "approve" that new system permission before it can be used. Contrary to the intended controls, we found that both system administrator permissions were assigned to the same position (Treasury Analyst). As a result, the

Treasury Analyst had the ability to create and assign new system permissions for initiating and approving transactions to the same employee (or a fictitious employee), thereby increasing the risk of inappropriate wire transfers of City pension funds.

To ensure the proper segregation of incompatible duties and reduce the risk of improper (fraudulent) wire transfers, we recommend that one of the system administrator permissions currently assigned to the Treasury Analyst be reassigned to a different managerial employee (e.g., the Deputy Treasurer-Clerk).

Authorization instructions sent to the custodian and to the City's third party administrator need to be updated. Good internal control practices for the wire transfer of funds provide that applicable entities be notified in writing of the specific individuals authorized to execute transactions and to specify and restrict the bank accounts to which those funds may be submitted.

The Treasurer-Clerk's Office needs to update authorization instructions sent to the custodian and third party administrator.

In regard to cash withdrawals of pension assets from the custodian, we noted that there is a letter, dated May 3, 2002, sent by the Treasurer-Clerk to the custodian that specified (1) the individual City employees authorized to direct the transfer of funds from the custodian to the City and (2) the specific bank and bank account into which those funds must be sent. In addition, the letter provides that any changes to those instructions must be authorized in writing by two of four specified individuals (Treasurer-Clerk, Treasurer-Clerk Analyst, Mayor, and City Manager). All instructions in that four-year old letter were still applicable, except that that the letter listed the former mayor and former name of the applicable banking institution.

Similarly, in regard to cash withdrawals of assets from the third party administrator (Prudential) for the MAP Program (defined contribution plan), we noted that there is a letter, dated May 6, 2002, sent by the Treasurer-Clerk to Prudential that specified (1) the two City employees authorized to direct the transfer of funds from the City's MAP Program account (i.e., for purposes other than MAP Program payouts to eligible retirees), (2) that the signature of both employees was required before a transaction is authorized, and

(3) the specific bank and bank account into which those funds must be sent. Similar to the previous paragraph, all data was current except that the letter listed the former name of the applicable banking institution.

We recommend that these instructions to the custodian and third party administrator be updated to reflect the current mayor and/or current name of the banking institution. In addition, to clearly document the custodian's and administrator's receipt and acknowledgement of the responsibilities established in the instructions, we recommend that the Treasurer-Clerk request that the appropriate custodian and administrator representatives sign, date, and return copies of the updated letters to the City. Furthermore, to ensure all entities remain aware of their responsibilities, we recommend that this process be performed annually, regardless of whether there are any changes in applicable elements or responsibility.

Records should be retained to document all cash withdrawal authorizations and requests.

Records were not always retained to document authorizations for cash withdrawals from the custodian. When a determination is made that cash funds should be withdrawn from the custodian (e.g., to fund current pension payments), designated Treasurer-Clerk staff prepares, signs, and sends letters to the custodian requesting and authorizing the withdrawals of funds. During calendar year 2005, we noted that four such requests were made. The amounts of the resulting transfers were $3.5 million, $4 million, $2 million, and $1.4 million. We noted that Treasurer-Clerk staff was not able to locate in their files copies of two of the four signed authorization letters sent to State Street for these withdrawals. We were subsequently able to obtain copies of the signed requests directly from the custodian. To substantiate within City records that requests are valid and authorized, we recommend that the Treasurer-Clerk prepare and retain, within established files, copies of each signed withdrawal authorization letter submitted to the custodian.

Because of the significant dollar amounts transferred between the City and other entities, consideration should be given to

enhancing current insurance coverage. The City currently has a government crime policy, which insures the City for up to $1 million per occurrence of employee theft. The Treasurer-Clerk relies on this insurance coverage as well as other controls placed into operation to reduce the risk of loss through unauthorized diversions of pension assets by City staff. Fidelity bonds are not obtained for individual employees as a result.

Because of the dollar value of pension funds wire transferred to and from other entities by certain Treasurer-Clerk staff, consideration should be given to enhancing current insurance coverage for employee theft.

We noted that cash withdrawals of pension assets generally exceeded the $1 million insurance cap. For example, during calendar year 2005, Treasurer-Clerk staff withdrew funds from the custodian four times, each withdrawal exceeding $1 million (i.e., $3.5 million, $4 million, $2 million, and $1.4 million, respectively).

To further reduce the risk of unrecoverable losses occurring from unauthorized employee diversions, we recommend that the Treasurer-Clerk's Office consider (1) increasing the insurance cap under the existing policy or (2) purchasing separate fidelity bonds for applicable employees in the Treasurer-Clerk's Office that execute wire transfers, in amounts sufficient to insure the City for potential fraudulent wire transfers.

Treasurer-Clerk staff did not verify that external managers reconciled their records/activity to the records/activity reported by the custodian. The City investment policy for the defined benefit plan requires external mangers to reconcile their asset and transaction ledgers with records of the custodian (State Street) within 30 days after the end of each quarter. The policy further provides that in the event of significant variances that cannot be resolved, the external manager should notify the City on a timely basis. Such reconciliations represent a control to detect any errors or fraudulent activity committed by custodian staff.

Treasurer-Clerk staff needs to ensure that external managers are timely and properly reconciling their recorded activity with the reports and records of the custodian.

This issue was also addressed in a prior audit of the City's investment function. (See City Auditor Report #0221, issued May 23, 2002.) In response to that prior audit finding, Treasurer-Clerk staff made inquiries of the applicable external managers. In response to those inquiries, each of the managers indicated that they did perform the desired reconciliations. In addition, the Treasurer-

Clerk staff responded that all subsequent contracts with external managers would contain provisions requiring the managers to (1) reconcile to the custodians records, (2) report any unresolved differences to the Treasurer-Clerk's Office, and (3) make evidence of those reconciliations available to City staff upon appropriate requests.

During this current audit of pension investments, we noted that six new contracts had been executed with managers since the stated corrective action resulting from our prior audit of the investment function. However, contrary to the stated planned action, we noted that none of those contracts contained terms requiring the reconciliations. We did note that evidence was available that four of the 16 current external managers were reconciling their records with the custodian. While the other 12 external managers may be reconciling their records and activity with the records and activity as reported by the custodian, Treasurer-Clerk staff has not obtained assurance that such reconciliations were done.

For external managers other than real estate managers, we did note that there was somewhat of a compensating control. Specifically, the independent investment consultant (Segal) asserted that it reconciles yields and rates of return reported by external managers (other than real estate managers) to that reported/reflected by the custodian. If that is done, then those reconciliations should provide some level of assurance that activity reported by the custodian is accurate and correct. However, in regard to real estate managers, there is no compensating control. (NOTE: If these reconciliations had been timely performed, the issue addressed [in a previous section of this report] regarding a real estate manager incorrectly sending cash distributions directly to the City instead of the custodian would have been timely detected.)

As a means to obtain reasonable assurance that the custodian is accurately and correctly safeguarding and accounting for City pension investments, we recommend that the Treasurer-Clerk staff require periodic statements from applicable external managers certifying that they are performing the required reconciliations.

Those managers should be required to report to Treasurer-Clerk staff any significant unresolved errors or differences. As formerly noted in our prior audit, this reconciliation requirement should also be included in all contracts subsequently executed with external managers.

IAC meeting minutes documenting key decisions and discussions should be formally reviewed and approved by Treasurer-Clerk management and the IAC.

Minutes prepared by Treasurer-Clerk staff for the quarterly meetings of the Investment Advisory Committee (IAC) should be formally reviewed and approved by Treasurer-Clerk management and the IAC. The City's Investment Advisory Committee (IAC) is comprised of three responsible members of the local business community who are appointed by the City Commission. Duties of the IAC include:

- Meeting with the Treasurer-Clerk on at least a quarterly basis to review pension investment performance.
- Making recommendations to the City Sinking Fund Commission (comprised of the IAC and City Commission) related to any aspect of the investment of pension assets, as they deem necessary.
- Immediately notifying the Treasurer-Clerk in the event any information comes to their attention that may negatively impact any of the investment managers hired by the City, or any of the individual investments.

We found that the IAC did meet quarterly as required. In addition, we noted that designated Treasurer-Clerk staff prepared minutes of these meetings. However, those minutes were not provided to Treasurer-Clerk management and IAC members for formal review and approval. Because key recommendations and decisions (e.g., to hire or fire specific managers and the reasons therefore) are made in these quarterly meetings, formal minutes should be prepared and reviewed/approved by Treasurer-Clerk management and presented to the IAC at the subsequent meeting for their review and approval (acceptance of minutes), as a means of documenting key decisions made and discussions held in those meetings. Accordingly, we recommend that IAC meeting minutes be formalized and submitted to Treasurer-Clerk management and the IAC (in subsequent meetings) for their review and approval.

Other Issues

During our audit we became aware of an internal control issue within Accounting Services that impacted not only pension investments but also, other City activity that involves the receipt and disbursements of City funds. This issue is addressed in the following comment.

We determined that bank account reconciliations performed by applicable Accounting Services staff were not adequate to detect errors in the processing of pension investment income.

Staff within Accounting Services did not perform adequate bank account reconciliations. Bank account reconciliations are performed as a measure to detect and correct accounting errors (made by either the bank or City staff) and also to assist in the detection of improper or fraudulent activity. In connection with our audit of pension investments, we reviewed the bank account reconciliation process performed by Accounting Services for the purpose of determining why those reconciliations did not detect instances where an external real estate manager incorrectly wire transferred cash distributions (income earned on investments) to the City's operating bank account (i.e., instead of sending those funds to the custodian).

Our review showed that while applicable Accounting Services staff had identified those receipts as unresolved reconciling items, no attempts were made to resolve those and other reconciling items. Upon further review, we determined that the reconciliation process was flawed as the reconciler was incorrectly netting all unreconciled items and carrying that net balance forward to the next month. Any unreconciled items identified in the next month were netted against the balance brought forward from the prior month.

This flawed approach resulted in none of the unreconciled items (including pension cash distributions that were incorrectly received by the City instead of the City's custodian) being researched and resolved. Upon identification of this process, Accounting Services management initiated immediate corrective action. That action included researching and identifying all individual items that comprised the net unreconciled balance, and making appropriate adjustments in the City's accounting records (or having the bank adjust their records if appropriate). In addition, we noted that different staff now performs the bank account reconciliation function. We recommend that Accounting Services continue with their corrective action. In addition, Accounting Services management should enhance their reviews of the reconciliation process to ensure that it is being correctly performed.

Conclusion

Overall, the City has met or exceeded its investment return goals resulting in a financially sound pension plan; however, improvements are needed in the areas of (1) monitoring and oversight, (2) formal policies and procedures, (3) documentation and (4) internal controls.

Overall, we found that the City has met or exceeded its investment return goals for its pension investments. The City's pension programs are in sound financial condition, in part, because of this successful investment of pension assets by the Treasurer-Clerk's Office. Notwithstanding this investment success, we noted several areas where improvements and enhancements are needed to the monitoring and oversight function of various pension investment activities. Policies and procedures should be developed and/or enhanced to assist Treasurer-Clerk staff in this process. Also, better documentation needs to be prepared and/or retained. To reduce the risk of errors or unauthorized diversions of pension assets, improvements should also be made to the control structure over pension investment transactions. Lastly, adjustments should be made to certain investments (international securities) to bring the City's investment portfolio in compliance with state statutes governing the investments of police office and firefighter pension assets.

Specific recommendations were made to address these issues.

We would like to acknowledge the full and complete cooperation and support of Treasurer-Clerk and Accounting Services staff during this audit.

Response From Appointed Officials

City Treasurer-Clerk:

We are very pleased with the findings reported by the City Auditor in the Pension Investments Audit. We agree with their recommendations and will implement the recommended procedural changes and recommended increased documentation of our operating procedures. We are also very pleased that the audit confirmed that the City's General, Police and Fire Defined Pension plans are fully funded; that in nine of the past ten years the plans performance exceeded the performance of two separate peer groups; over the past decade we have exceeded our investment policy benchmark and the plan's actuarial assumption; and that our investments were made in compliance with governing State and City legal requirements. We wish to commend the audit staff for thoroughly addressing a very complicated issue and providing some very useful and constructive recommendations.

City Manager:

I appreciate the City Auditor's thorough review of this process. My staff is committed to improving the process as recommended. I would like to thank the City Auditor and his staff for their cooperative efforts.

Appendix A – Action Plan

Action Steps	Responsible Employee	Target Date
OFFICE OF THE TREASURER-CLERK		
A. Objective: To ensure compliance with controlling laws and regulations.		
1. Appropriate adjustments will be made to defined benefit plan investments such that no more than 10% of police and firefighter plan assets are invested in international securities.	Jim Cooke	12/31/06
2. The defined benefit plan investment policy will be revised to provide that no more than 10% of plan assets "owned" by the police and firefighter plans will be invested in international securities.	Jim Cooke	5/31/07
B. Objective: To ensure an adequate and appropriate investment policy.		
1. A separate investment policy will be established for the City's defined contribution plans. Essential elements (e.g., as addressed and suggested in the audit report and as recommended by industry guidance) will be addressed by that policy.	Jim Cooke	12/31/06
2. The defined benefit plan policy will be revised to (1) provide for a system of internal controls and (2) documented operational procedures.	Jim Cooke	5/31/07
3. The defined benefit policy will be modified to clarify that investment of plan assets in real estate are not limited to the one named external manager.	Jim Cooke	5/31/07
C. Objective: To ensure adequate monitoring and evaluation of investment performance.		

Action Steps	Responsible Employee	Target Date
1. The investment consultant will be requested to measure and report investment performance net of fees as required by the City's defined benefit investment policy.	Jim Cooke	7/31/06
2. Future contracts executed with external investment managers will address investment policy benchmarks.	Jim Cooke Tom Carman	See Note A
3. Procedures and methods for the evaluation of investment performance for both the defined benefit and defined contribution plans will be formalized and documented.	Jim Cooke	12/31/06
D. Objective: To ensure appropriate selection of external managers and investment funds using a competitive, merit-based approach.		
1. Adequate documentation will be prepared and retained that explains and justifies decisions made in selecting managers and funds to be interviewed from the "pool" of potential entities identified by the investment consultant.	Jim Cooke Tom Carman	See Note A
2. Adequate documentation will be prepared and retained that explains and justifies decisions made in the final selection of managers and funds.	Jim Cooke Tom Carman	See Note A
3. For the defined contribution plans, adequate documentation will be maintained showing specific funds evaluated and considered as well as the criteria and factors used to evaluate those funds.	Jim Cooke Tom Carman	See Note A
4. Procedures used in the selection and hiring of external managers and investment funds will be formalized and documented.	Jim Cooke Tom Carman	12/31/06
E. Objective: To ensure proper fees are paid to the custodian.		
1. Staff will enhance their review of custodian fee invoices to ensure that invoiced amounts are in accordance with contractual terms and fee schedules.	Jim Cooke Tom Carman	12/31/06

Action Steps	Responsible Employee	Target Date
2. Staff will determine if the undercharge reported by the custodian is accurate in amount. In the event that substantiated undercharges are less than the identified overcharges, funds will be recovered from the custodian for the difference.	Jim Cooke Tom Carman	12/31/06
3. State Street will be requested to make available detail of the individual trade transactions for which the City is charged. Staff will use that information to develop a baseline of reasonable transactions, against which future invoiced transactions can be compared. Any unexpected variations from that baseline will be investigated for the purpose of ensuring invoiced trade fees are reasonable.	Jim Cooke Tom Carman	12/31/06
4. Procedures for reviewing custodian invoices and ensuring that invoiced fees are correct and reasonable will be documented.	Jim Cooke Tom Carman	12/31/06
F. Objective: To ensure external mangers comply with policy and contractual provisions and requirements.		
1. The one manager where the audit identified investments in unallowable instruments addressed by the City's investment policy will be instructed to reinvest those assets in allowable instruments.	Jim Cooke Tom Carman	7/31/06
2. The two managers where the audit identified investments outside the parameters allowed by the applicable contracts will be instructed to reinvest those assets within those parameters.	Jim Cooke Tom Carman	7/31/06
3. Formal written procedures will be developed and implemented to address the process of approving payment of manager fees based on manager-reported values instead of custodian-reported values. Those procedures will provide for a dollar threshold to delineate when fees should be paid as invoiced or rejected and instead be paid based on custodian-reported values.	Jim Cooke Tom Carman	12/31/06
4. Future contracts with external managers will address, either by direct reference or through an attached	Jim Cooke	See Note A

Action Steps	Responsible Employee	Target Date
appendix, required compliance with key investment policy requirements.	Tom Carman	
5. All applicable contractual documents, including fee schedules, will be timely obtained and retained in Treasurer-Clerk files. Filing efforts will be improved such that those records will be made available upon appropriate request in a timely manner.	Tom Carman	12/31/06
6. A formal process will be developed and implemented for the purpose of ensuring that external managers comply with key policy and contractual provisions and requirements.	Jim Cooke Tom Carman	12/31/06
7. As part of the process developed pursuant to the preceding action step, a standardized checklist will be developed and periodically completed for each external manager to assist in determining and verifying compliance (or noncompliance). Completed checklists and any other applicable records will be retained as evidence of this monitoring process.	Jim Cooke Tom Carman	12/31/06
G. Objective: To ensure reported security lending income is accurate and proper.		
1. A formal process will be developed and implemented for the periodic review of reported security lending activity to ensure that function is properly and efficiently administered and reported earnings are reasonable.	Jim Cooke Tom Carman	12/31/06
H. Objective: To ensure adequate internal controls are in place.		
1. One of the system administrator permissions currently assigned to the Treasury Analyst will be reassigned to the Deputy Treasurer-Clerk.	Gary Herndon Jim Cooke	7/31/06
2. Authorization instructions for the custodian and the third party administrator will be updated to reflect the current Mayor and bank.	Tom Carman	7/31/06
3. Authorization instructions will be updated and re-sent or reconfirmed at least annually. To document the custodian's and third party's receipt and acknowledgement of those instructions, those entities	Tom Carman	12/31/06

Action Steps	Responsible Employee	Target Date
will be required to sign, date, and return copies of the submitted instructions to Treasurer-Clerk staff. Those signed and dated acknowledgements will be retained in Treasurer-Clerk files.		
4. Copies of each signed withdrawal authorization letter sent to the custodian will be retained in Treasurer-Clerk files.	Tom Carman	12/31/06
5. To better protect the City in the event of unauthorized transfers of pension funds, the Office of the Treasurer-Clerk will either (1) increase the current $1 million insurance cap under the existing government crime policy or (2) purchase separate fidelity bonds for applicable employees in the Treasurer-Clerk's Office, in amounts sufficient to insure the City for potential fraudulent wire (or electronic) transfers.	Jim Cooke Gail Shuffler	12/31/06
6. External managers will be required to submit periodic statements certifying that they are reconciling their records and activity with the records and activity as reported by the custodian. External managers will be required to report to Treasurer-Clerk staff any unresolved errors or differences.	Tom Carman	12/31/06
7. Future contracts with external mangers will require that the manager (1) reconcile their records and activity with that reported by the custodian, (2) report any significant unresolved errors or differences, and (3) periodically certify to the Treasurer-Clerk that these reconciliations are being performed.	Jim Cooke Tom Carman	See Note A
8. Investment Advisory Committee (IAC) minutes will be provided to Treasurer-Clerk management and IAC members for their formal review and approval.	Tom Carman	12/31/06
Accounting Services		
1. The bank account reconciliation process will be corrected such that unresolved differences are adequately identified, researched, and either resolved or reported to management.	Rick Feldman Mazie Crumbie	12/31/06

Action Steps	Responsible Employee	Target Date
2. Accounting Services management will enhance the review of bank account reconciliations.	Rick Feldman Mazie Crumbie	12/31/06

NOTE A: Plans are in place to implement when applicable future actions occur.